[Fordham Urban Law Journal](https://ir.lawnet.fordham.edu/ulj)

Volume 15 | Number 4 Article 5

1987

The Misappropriation Theory: Rule 10b-5 Insider Liability for Nonfiduciary Breach

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THE MISAPPROPRIATION THEORY:* RULE 10b-5 INSIDER LIABILITY FOR NONFIDUCIARY BREACH

I. Introduction

The recent increased public awareness of insider trading[1] is directly attributable to increased enforcement by courts and the Securities

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* As this book was going to press, the Supreme Court decided Carpenter v. United States, 108 S. Ct. 316 (1987). With Justice Powell's replacement not yet confirmed, the eight-member court: (1) held that the defendants' misappropriation of information from The Wall Street Journal violated the federal wire and mail fraud statutes; and (2) upheld, by a 4-4 vote, the defendants' convictions for violating section 10(b) and Rule 10b-5. Because the Court reached the latter determination by an equally divided vote, the determination does not establish a national precedent and leaves the issues raised in this Note for future consideration.

1. As discussed later, *infra* notes 32-34 and accompanying text, the basic tenet of the prohibition against insider trading is that certain persons with knowledge of material nonpublic information about an issuer's securities must either disclose that information or refrain from trading in those securities. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 1 (1982); Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1219 n.2 (1981); Note, *An Outsider Looks at Insider Trading:* Chiarella, Dirks *and the Duty to Disclose Material Nonpublic Information,* 12 FORDHAM URB. L.J. 777, 777 n.1 (1984) [hereinafter *An Outsider Looks at Insider Trading*].

The recent interest in the insider trading area was sparked by the case of Dennis Levine. On May 12, 1986, the Securities Exchange Commission (SEC) filed the largest insider trading enforcement action in history. Levine, formerly associated with Drexel, Burnham & Lambert, Inc., was charged with reaping $12.5 million in profits by trading on nonpublic information concerning approximately 54 proposed mergers and takeovers. *See* SEC v. Levine, No. 86 Civ. 3726 (S.D.N.Y. filed May 12, 1986). The *Levine* case achieved great media attention, not only because Levine was a member of the arbitrage community, *see infra* note 134, but also because the three brokerage houses employing him had worked on only a few of the mergers or takeovers of which he took advantage. *See* Obermaier, *Who's an Insider? What's Inside?*, N.Y.L.J., July 1, 1986, at 1, col. 1 [hereinafter Obermaier].

Paul A. Cohen, Chairman and Chief Executive Officer of Shearson Lehman Brothers, Inc., termed the affair "the worst disaster for Wall Street in the past 10 years." BUS. WK., June 9, 1985, at 82. The SEC complaint against Levine alleged that he had received information "under circumstances in which Levine knew or had reason to know, or acted in reckless disregard of the fact, that the information was confidential and had been obtained through misappropriation or breach of fiduciary duty or other relationship of trust and confidence or other wrongful acts." Complaint, SEC v. Levine, No. 86 Civ. 3726 (S.D.N.Y. filed May 12, 1986). While it is obvious that the SEC has been thorough in its research, the allegations in its pleadings go well beyond its own rules. In this regard, the SEC's reach may very well be exceeding its grasp. Several commentators assert that the SEC overstepped its bounds in the complaint. *See* Lewin, *Some Assert SEC Pushes*

Exchange Commission (SEC) of prohibitions against that trading.[2] The Supreme Court, in *Chiarella v. United States*,[3] left open the question of whether section 10(b) of the Securities Exchange Act of 1934[4] and Rule 10b-5[5] should operate against what is commonly

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Too Far, N.Y. Times, July 21, 1986, at D-1, col. 3.

The information supplied by Mr. Levine led to SEC allegations of trading on inside information against arbitrageur Ivan Boesky on November 14, 1986. *See* N.Y. Newsday, Feb. 12, 1987, at 5, col. 1; *see also* SEC v. Boesky, No. 86 Civ. 8767 (S.D.N.Y. filed Nov. 14, 1986). Mr. Boesky settled his case with the SEC for $100 million in fines and disgorged profits. *See* N.Y.L.J., Nov. 25, 1986, at 1, col. 2. The Boesky affair has been termed "the greatest scandal to rock Wall Street in a generation, if not since before the crash of 1929." *Id.* The allegations in the Boesky complaint, which also included an allegation of misappropriation, *see infra* notes 80-122 and accompanying text, evince the same excessive reach by the SEC as those in the Levine complaint. *See* Complaint 11, SEC v. Boesky, No. 86 Civ. 8767 (S.D.N.Y. filed Nov. 14, 1986) [hereinafter Boesky Complaint]. The Commission alleged, *inter alia*, that Boesky had been tipped by Levine, who had in turn been tipped by someone else in breach of a fiduciary duty "or by misappropriation." Boesky Complaint, *supra*, at 11-13. The former allegation rests on the theory established in Dirks v. SEC, 463 U.S. 646 (1983), *see infra* notes 60-79 and accompanying text, while the latter follows from the unprecedented Second Circuit holdings of recent years. *See infra* note 81. In the wake of the *Boesky* settlement, the SEC has suggested that its insider trading investigation will soon turn to entirely new areas. *See* N.Y.L.J., Nov. 18, 1986, at 1, col. 2.

Other significant recent developments in this area include the SEC disciplinary proceeding against First Boston Corp., the first disciplinary action against the corporation in its 52 year history. *See* Bus. Wk., May 19, 1986, at 125. On June 3, 1986, in the largest award ever in a contested insider trading case, two co-defendant were found civilly liable for $3.5 and $1.3 million by Judge Pollack, of New York's Southern District, for "callously" taking advantage of Edgar Bronfman, Seagram's Chairman and Chief Executive Officer, in obtaining inside information. *See Judge Finds 2 Men Guilty Of Inside Trades,* Wall St. J., June 4, 1986, at 2, col. 2.

2. Scholarly criticism has challenged the viability of the insider trading laws. *See, e.g.*, H. MANNE, INSIDER TRADING IN THE STOCK MARKET (1966) [hereinafter INSIDER TRADING IN THE STOCK MARKET]; Phillips, *The Insider Trading Doctrine: A Need For Legislative Repair*, 13 HOFSTRA L. REV. 65 (1984); Note, *Financial Reporters, the Securities Laws and the First Amendment: Where to Draw the Line*, 53 FORDHAM L. REV. 1035 (1985) [hereinafter *Financial Reporters*]. Some articles favor the broad interpretation by the courts of the insider trading antifraud provisions. *See* Note, *The SEC's Regulation of the Financial Press: The Legal Implications of the Misappropriation Theory*, 52 BROOKLYN L. REV. 43 (1986); *see also* Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information,* 13 HOFSTRA L. REV. 101 (1984) [hereinafter *Misappropriation: A General Theory of Liability*]. Other articles have criticized the courts' extension of Rule 10b-5, through the misappropriation theory, to trading by financial reporters based on their own analyses. *See, e.g.*, Note, *The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters*, 38 STAN. L. REV. 1549 (1986).

3. 445 U.S. 222 (1980).

4. *See infra* note 25.

5. *See id.*

called "misappropriation."[6] The misappropriation theory basically incorporates common law fiduciary concepts within the ambit of federal securities statutes regulating the purchase and sale of securities.[7] In a significant and controversial decision, the Second Circuit recently affirmed the conviction of R. Foster Winans, a former *Wall Street Journal* reporter, for securities fraud and mail and wire fraud.[8] By extending Rule 10b-5 insider trading liability to include the misappropriation theory,[9] this decision has greatly expanded the scope of that liability.

Responsibility for this unprecedented expansion lies with the SEC for failing to promulgate a rule defining insider trading. This Note, however, does not reach the question whether insider trading prohibitions should be repaired.[10] Rather, its purpose is to demonstrate

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6. *See infra* notes 80-122 and accompanying text. Justice Stevens, in his concurrence, suggested that "respectable arguments could be made in support of either position . . . . I think the Court wisely leaves the resolution of this issue for another day." *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring).

7. For a more detailed discussion of the misappropriation theory, see *infra* notes 80-122 and accompanying text.

8. The nonjury conviction of Winans and two co-defendants was affirmed by a vote of two-to-one. United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986). *Carpenter* is more commonly known as the *Winans* case, but for the purposes of this Note it will be referred to as *Carpenter*. *See* Taylor, *Winans Case Taken By Justices: Insider Rules Among Issues*, N.Y. Times, Dec. 16, 1986, at D1, col. 3.

9. *See infra* notes 80-122 and accompanying text.

10. Many articles have criticized the insider trading laws. *See supra* note 2. These articles have also proposed new rules and standards for the SEC to adopt in determining insider trading liability. In June, 1986, Congress began hearings on insider trading. Former SEC Chairman John S. R. Shad testified that "no new legislation was necessary to combat problems with insider trading." N.Y. Times, June 19, 1986, at D6, col. 5. He informed Congress that as of the date of his testimony, the SEC had recovered $25 million in illicit insider trading profits from 18 insider trading cases—compared to the 20 cases in all of 1985 of which $11 million was recovered from the Levine settlement alone. *See id.* Shad cautioned Congress, however, that while "[t]here is too much insider trading . . . it should not be exaggerated out of proportion." *Id.* This statement followed an earlier proposal by Mr. Shad that the SEC offer rewards for information on those who spread rumors and trade on inside information. *Id.*

Furthermore, the SEC opposed the inclusion of a definition of insider trading when Congress considered and passed the Insider Trading Sanctions Act of 1984. 15 U.S.C. § 78(d)(2)(A) (Supp. II 1984). The SEC has also opposed any amendment to the Exchange Act to include such a definition. One such definition the SEC could have easily adopted appears in the proposed Federal Securities Code. FED. SEC. CODE § 1603(b) (1980). The absence of such a definition explains the courts' deviation from, and expansion of, the insider trading laws, specifically Rule 10b-5, to include the misappropriation theory. *See* Obermaier, *supra* note 1, at 2, col. 4.

On August 7, 1987, the SEC proposed a bill to define insider trading. If the inappropriateness and detriment of extending those already flawed prohibitions by adopting a misappropriation theory.

In Part II, this Note surveys the history of section 10(b) and Rule 10b-5[11] and monitors their application in early judicial decisions.[12] After discussing the period of judicial and administrative expansion of liability under these antifraud provisions,[13] the Note turns to those decisions restricting the provisions' bounds.[14] This Note then discusses *United States v. Carpenter,* in which the Second Circuit expanded insider trading liability to the greatest degree yet.[15] The Note will then show how the misappropriation theory does not fit within the statutory purposes of these provisions.[16] Congress and the SEC did not intend to include misappropriation when they enacted and promulgated these provisions. Extending the provisions to reach the growing problem of insider trading goes against basic premises of statutory construction consistently articulated throughout the history of the Court.[17]

II. The History of the Misappropriation Theory

Section A of this part will explain the purposes and policies behind the enactment and promulgation of section 10(b) and Rule 10b-5. Section B will follow with discussion of some early decisions applying these provisions and of the later expansion of these provisions by the SEC and the courts. Section C will illustrate the Supreme Court's return to the traditional principles of insider trading liability established by the early decisions.

A. The Exchange Act: Its Purpose and Intentions

In the midst of the Great Depression, Congress created the SEC in the Securities Exchange Act of 1934 (Exchange Act).[18] The Exchange Act, which primarily regulates trading of securities on the

passed, it is said the bill will strengthen prosecution in "less clear-cut cases" of insider trading. *S.E.C. Goal: Sharp Aim in Vague Insider Cases*, N.Y. Times, August 7, 1987, at D1, col. 1.

11. *See infra* note 25.
12. *See infra* notes 32-38 and accompanying text.
13. *See infra* notes 39-43 and accompanying text.
14. *See infra* notes 44-79 and accompanying text.
15. *See infra* notes 80-122 and accompanying text.
16. *See infra* notes 123-46 and accompanying text.
17. *See infra* notes 149-60 and accompanying text.
18. Securities Exchange Act, ch. 404, 48 Stat. 881, 885 (1934) (codified as amended at 15 U.S.C. § 78d (1982)).

stock exchanges and the over-the-counter market,[19] delegated broad regulatory powers to the SEC to protect investors from fraud in securities transactions.[20]

The Exchange Act, including section 10(b), was one of a series of statutes designed:

> [T]o eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's . . . . A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.[21]

Thus, as is evidenced by the Senate Report accompanying the Securities Act of 1933,[22] the securities laws were enacted to protect the investing public, to provide the public with full disclosure of

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19. *See infra* note 20. Note, however, that the Exchange Act is not the only means of such regulation. In United States v. Naftalin, 441 U.S. 768 (1979), the Court ruled that although the Exchange Act and the Securities Act of 1933 overlap in some cases involving similar conduct, the 1933 Act still applied. *Id.* at 777-78. Although the 1933 Act was primarily concerned with regulating new offerings, section 17(a) of the 1933 Act "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." *Id.* at 778.

20. *See* OFFICE OF THE FEDERAL REGISTER, THE U.S. GOVERNMENT MANUAL 613 (rev. ed. 1985).

21. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963) (footnotes omitted). The Court went on to say: " 'It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry." *Id.* at 186-87 (quoting Silver v. New York Stock Exch., 373 U.S. 341, 366 (1963)).

22. S. REP. No. 47, 73d Cong., 1st Sess. 1 (1933). The Senate Report clearly evidences Congress' intent in enacting the securities laws:

> The purpose of this bill is to protect the investing public and honest business . . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consumer power.

Id.; *see also* Radzanower v. Touche Ross & Co., 426 U.S. 148, 155 (1976) (primary purpose of Exchange Act is to provide "fair and honest" mechanism for trading by investors).

material securities-related information, to protect the public from fraud and to promote honest and fair dealing in the marketplace,[23] and to preserve the integrity of the market.[24]

Rule 10b-5, which the SEC promulgated in 1942 pursuant to section 10(b) of the Exchange Act,[25] has long been the primary tool by

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23. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976). In *Ernst*, the Court stated:

> The 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.

Id.; *see also* Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 26-29 (1977) (enactment of Williams Act continued Exchange Act's basic theme of investor protection); SEC v. Southwest Coal & Energy Co., 624 F.2d 1312, 1318 (5th Cir. 1980) (primary goal of federal securities laws is to give investor benefit of full disclosure to allow intelligent investment decisions); Lank v. New York Stock Exch., 548 F.2d 61, 65 (2d Cir. 1977) (intended beneficiary of Exchange Act is public investor).

24. *See supra* note 22.

25. The SEC promulgated Rule 10b-5 in 1942 under the authority of section 10(b). The rule reads as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) 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 (1987).

Section 10(b) is one of the major antifraud provisions of the Exchange Act. 15 U.S.C. § 78a-78kk (1982). Section 10(b) states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (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. § 78j(b) (1982). The other anti-fraud provision, section 15(c)(1), prohibits any broker or dealer from inducing the purchase or sale of securities through "manipulative" or "deceptive" devices. *Id.* § 78o(c)(1) (1982).

Rule 10b-5 must not be a tool for protecting the relationship between an employer and employee. *See infra* notes 80-160 and accompanying text. Congress did not intend that the common law rule protecting that relationship be encompassed within which the Commission has combatted insider trading.[26] Traditionally, an individual is liable under Rule 10b-5 when he has obtained material

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the scope of Rule 10b-5. Indeed, the "scope [of Rule 10b-5] cannot exceed the power granted the Commission by Congress under § 10(b)," *Ernst*, 425 U.S. at 214, which only prohibits the use of a "manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b) (1982). The general fraud provisions of Rule 10b-5, however, make it unlawful "to employ any device, scheme, or artifice to defraud" or engage in an "act, practice, or course of business which operates . . . as a fraud or deceit." 17 C.F.R. § 240.10b-5 (1987). The plain meaning of the rule and statute purports to prevent failures to disclose only when the non-disclosure amounts to a "manipulative or deceptive device or contrivance," but does not encompass frauds made by an employee against his employer that are not related to disclosure. *See Ernst*, 425 U.S. at 214. Congressional concern in enacting section 10(b) focused on preventing the use of manipulative and deceptive devices in connection with the purchase or sale of a stock—a practice with the danger of artificially and wrongfully affecting the market price of the security. *See supra* note 2 and accompanying text. It should be noted that the language contained in section 10(b) was originally in section 9(c) of the Senate and House bills. *See* S. REP. No. 2693, 73d Cong., 2d Sess. (1934); H.R. 7852, 73d Cong., 2d Sess. (1934); *see also* H.R. REP. No. 8720, 73d Cong., 2d Sess. (1934). The committee hearings regarding the language of section 9(c) reveal that it was intended to cover all types of manipulation and deception not covered in other subsections of section 9. *See Hearings on Stock Exchange Regulations Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934). Other subsections of section 9 cover various specific practices which have the potential to result in a false appearance of active trading thereby artificially effecting the market. For example, "short" sales and "stop-loss" orders. Trading on nonpublic material information, it has been argued, does not artificially affect market price. Rather, it tends to push the market price of a security in the right direction. *See generally* INSIDER TRADING IN THE STOCK MARKET, *supra* note 2 (prohibition against insider trading ignores goals of allocative market efficiency); Note, *Leveraged Buyout, Management Buyout, and Going Private Corporate Control Transactions: Insider Trading or Efficient Market Economics?*, 14 FORDHAM URB. L.J. 685, 705-706 [hereinafter *Leveraged Buyout*]; *An Outsider Looks at Insider Trading*, *supra* note 1, at 790. Therefore, Congress' intention may not be served by including acts of trading on material nonpublic information within the ambit of the words "manipulative or deceptive device or contrivance." *See id.* In fact, many commentators have asserted that insider trading, in general, has no harmful effect on the securities markets. *See id.*; *see also* Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1 (1980); Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities Exchange Commission, 13 HOFSTRA L. REV. 127 (1984); Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984); Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968). In a television interview, an authority on trading in the securities markets asserted that the SEC crackdown on insider trading was a serious mistake. Interview by David Brinkley of Alan Greenspan, former Chairman of the President's Council of Economic Advisors and present Chairman of the Federal Reserve Board (Mar. 15, 1986).

26. As Justice Rehnquist noted in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), when dealing with Rule 10b-5 "we deal with a judicial oak which has grown from little more than a legislative acorn." *Id.* at 737. Justice Rehnquist noted that although Congress had intended for the rule to expand, the

nonpublic information[27] as a result of his position in a company and then trades on the basis of that information.[28] The securities acts were neither intended to regulate common law fiduciary duties between employers and employees,[29] nor to implement internal corporate policy.[30] Section 10(b) was intended to benefit the investing public and to preserve the integrity of the securities markets, not to deal with matters such as employer/employee duties or corporate policy.[31]

B. Origin and Expansion of the Misappropriation Theory

Insider trading has long been recognized as a breach of a fiduciary obligation to the shareholders of a corporation.[32] Thus, in the seminal

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Court ultimately held that it was not the intent of Congress to interpret the statute as it was. *Id.* The language of Rule 10b-5 and its history show that the structure of the "acorn" was not intended to include a branch such as the misappropriation theory, which would impose liability upon persons who misappropriate material nonpublic information but who do not owe any fiduciary duty to those persons upon whose information they traded. *See infra* notes 124-33 and accompanying text.

27. *See infra* note 34 and accompanying text.

28. For example, assume a person is in a position to learn of confidential corporate matters. He may obtain information about the company which is not known publicly, and then he may buy or sell stock in the company based on this information. The substance of this nonpublic information might involve an impending merger or acquisition of his company. The price of the stock of a target company typically rises when the news of an impending merger or acquisition becomes public. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 405 U.S. 1005 (1971). The corporate insider may, after receiving the nonpublic information, purchase stock of the target corporation, and when the merger or acquisition is announced, sell the stock for a profit.

29. Traditionally, this common law principle has been a matter of state law. *See, e.g.*, CVD, Inc. v. Raytheon Co., 769 F.2d 842 (1st Cir. 1985), *cert. denied*, 106 S. Ct. 1198 (1986); SI Handling Sys., Inc. v. Heisley, 753 F.2d 1244 (3d Cir. 1985); Zoecon Indus. v. American Stockman Tag Co., 713 F.2d 1174 (5th Cir. 1983); Rohm & Haas Co. v. Adco Chem. Co., 689 F.2d 424 (3d Cir. 1982); Hollingsworth Solderless Terminal Co. v. Turley, 622 F.2d 1324 (9th Cir. 1980); Southland Reship, Inc. v. Flegel, 534 F.2d 639 (5th Cir. 1976).

30. *See supra* notes 21-22 and accompanying text.

31. *See id.; see also* Marine Bank v. Weaver, 455 U.S. 551, 555 (1982). Chief Justice Burger noted in *Weaver* that in enacting the securities laws Congress "did not intend to provide a broad federal remedy for all fraud." *Id.* at 556. This Note will later illustrate how the misappropriation theory, as developed by Chief Justice Burger, contradicts the very principle he established in *Weaver. See infra* notes 80-160 and accompanying text.

32. *See* Kardon v. National Gypsum Co., 73 F. Supp. 798, 803 (E.D. Pa. 1947) (Exchange Act became effective through application of well-established fiduciary principles); *see also* Speed v. Transamerica Corp., 99 F. Supp. 808, 829 (D. Del. 1951) (corporate insider violated fiduciary duty to disclose).

case of *In Re Cady, Roberts & Co.*,[33] the SEC declared that a corporate insider has a duty to abstain from trading in the shares of his corporation unless he has first disclosed all material information known to him.[34] The Commission made it clear, however, that this duty to disclose exists only when the company maintains a "special relationship" with the individual trading its securities.[35] In the landmark insider trading case, *SEC v. Texas Gulf Sulphur Co.*,[36] this rule became known as the "disclose-or-abstain" rule. Subsequent to the *Cady, Roberts* and *Texas Gulf Sulphur* decisions, insider trading prohibitions underwent steady expansion.[37] As part of this expansion, courts and the Commission extended Rule 10b-5 liability to outsiders as well as insiders.[38]

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33. 40 S.E.C. 907 (1961).

34. The SEC stated that the fiduciary duty to disclose, or abstain from trading upon, material information under Rule 10b-5 "has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling shareholders. We, and the courts have consistently held that insiders must disclose material facts 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." *Id.* at 911.

35. *Id.* at 912. In doing so, the SEC pointed out that its "task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading its securities. Intimacy demands restraint lest the uninformed be exploited." *Id.*

36. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971); *see infra* note 58.

37. *See infra* note 38.

38. The traditional distinction between insiders and outsiders focused solely upon the definitions given by the SEC. Under section 16(a) of the Exchange Act, an insider is a director, officer or shareholder owning more than 10% of the equity securities of a corporation. *See* Exchange Act § 16(a), 15 U.S.C. § 78p(a) (1982).

This definition of insider was subsequently expanded by the courts. The first such expansion came in *Cady, Roberts*, an SEC administrative proceding in which the court found a broker-dealer liable under Rule 10b-5. *See supra* note 34. The broker allegedly had used confidential information regarding a corporate decision to cut a dividend in recommending that a customer sell a security. *See Cady, Roberts*, 40 S.E.C. at 909. The court applied the facts to two elements: first, the existence of a relationship giving access to inside information intended for a corporate purpose and second, the unfairness involved where a corporate insider takes advantage of the information by trading it without disclosure. *Id.* at 912. Thus, the Commission regarded the insider "relationship" in terms of access to nonpublic information rather than in terms of a common law fiduciary duty. *Id.; accord Chiarella*, 445 U.S. at 249. This interpretation comports with the principle that the antifraud provisions of the federal securities laws are not to be "circumscribed by fine distinctions and rigid classifications" as they were at common law. *Cady, Roberts*, 40 S.E.C. at 912.

A decade later, the SEC significantly expanded the *Cady, Roberts* rule in *In re* Investors Management Co., 44 S.E.C. 633 (1971). Apparently, differences of opinion at the SEC concerning the theoretical bases of insider trading liability

C. An End to the Expansion Era: *Chiarella*

Since the *Texas Gulf Sulphur* decision,[39] the SEC has argued that the antifraud provisions of the securities laws[40] mandate a parity of access to information among all traders in the securities markets.[41] Accordingly, the SEC has maintained that when a person comes into possession of material nonpublic information, regardless of whether he is an insider or a tippee,[42] the person must disclose or refrain from trading upon that information until it has been generally disseminated to the public.[43] The Supreme Court rejected this principle in *Chiarella v. United States*.[44] The Court relied on the well-established principles formulated in *Cady, Roberts*.[45] Chiarella, an employee of a financial printer, handled various documents including corporate announcements of takeover bids.[46] Although the names of the target corporations were purposely left blank or given dummy names, Chiarella was able to deduce the actual names of the target corporations.[47] He then purchased stock in these target corporations

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mandated the SEC to redefine the insider trading boundaries. *See id.* at 651. The SEC opinion in *Investors Management* set forth the doctrine that one who obtains material nonpublic corporate information which he has reason to know emanates from a corporate source, and which, by itself places him in a position superior to that of other investors, acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions of the securities laws. *See id.* at 643. Only the concurring opinion of SEC Commissioner Smith was adopted by the Second Circuit in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974), and subsequently by the Supreme Court in Dirks v. SEC, 463 U.S. 646 (1983). In his concurring opinion, Commissioner Smith posited that tippee liability, *see infra* note 71, must relate back to insider responsibility by a finding that the tippee knows the information was given to him through a breach of duty by a person with a "special relationship" to the issuer of the information not to disclose it. *Investors Management*, 44 S.E.C. at 651. Further, in addition to the requirement that the information be nonpublic and material, it must have contributed substantially to the trading that ensued. *See Dirks*, 463 U.S. at 655 n.14; *Investors Management*, 44 S.E.C. at 645.

39. *See supra* note 36.

40. *See supra* note 25.

41. *See Dirks*, 463 U.S. at 657.

42. *See id.* at 648-49.

43. *See id.* at 656-58. The Supreme Court does not impose a duty to disclose upon one who receives nonpublic information from an insider merely because the insider has such a duty. *Id.* at 657-58. Because no relationship existed and the *Dirks* Court rejected the SEC's theory, Dirks avoided liability under Rule 10b-5. *Id.* at 665. For a more detailed discussion of the *Dirks* case, see *infra* notes 60-79 and accompanying text.

44. 445 U.S. 222 (1980).

45. *See supra* notes 34-35.

46. *See Chiarella*, 445 U.S. at 224.

47. *See id.*

using this information and, immediately after the takeover was consummated, sold the stock at a profit.[48] As the employee of a financial printer, Chiarella owed no duty to the corporations whose securities he traded.[49] Thus, by reversing Chiarella's conviction,[50] the Court rejected the principle that the securities laws were intended to ensure equality of information in the marketplace or that buyers and sellers of securities owe a general duty to the trading markets.[51]

Aside from promoting disclosure and fair dealing, the securities laws do not purport to protect less informed buyers and sellers of securities from those who are better informed.[52] As the Supreme Court has stated: "[N]ot every instance of financial unfairness constitutes fraudulent activity under [section] 10(b)."[53] One does not assume a duty to disclose material information simply from an ability to obtain information that stems from one's status in the marketplace.[54] Rather, potential insider trading liability arises only when a party has legal obligations *beyond* a duty to comply with the antifraud provisions of the securities laws.[55] A duty to disclose or refrain from trading arises out of the "relationship" between the parties.[56] This relationship need not be that between a purchaser and seller of securities.[57] It has been suggested that misappropriation of material

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48. *See id.*

49. *See id.* at 235.

50. *See id.* at 237.

51. *See id.* at 231-32 n.14. In this footnote, the Court rejected the " 'regular access to market information' " test adopted by the Second Circuit. *Id.* at 231 n.14. The Second Circuit had relied on this test to create a rigid rule embracing " 'those who occupy . . . strategic places in the market mechanism.' " *Id.* (quoting United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980)). The Supreme Court, however, did not hold these considerations sufficient to support a duty to disclose. *See Chiarella*, 445 U.S. at 231-32 n.14.

52. *See id.* at 232.

53. *Id.; see* Sante Fe Indus., Inc. v. Green, 430 U.S. 462, 474-77 (1977).

54. *See Chiarella*, 445 U.S. at 231-32 n.14.

55. *See id.* at 232-33.

56. *See id.* at 232.

57. *See id.* at 236. The Court left open this question because it was not submitted to the jury. *See id.* at 236. The lower court instructed the jury to find only whether a duty existed between Chiarella and the sellers. *See id.* The Supreme Court, therefore, refused to speculate as to whether a breach of such duty constituted a section 10(b) violation. *See id.* Justice Stevens stated in his concurring opinion that persuasive arguments could be made that Chiarella's conduct would constitute a fraud or deceit upon his employer and his employer's clients *only if* he had a "duty to the acquiring companies that had entrusted confidential information to his employers," but that it could also be argued that there was no actionable violation of Rule 10b-5 because the clients were neither purchasers nor sellers of the target company's securities. *Id.* at 238 (Stevens, J., concurring). Stevens added that "the Court wisely leaves the resolution of this issue for another day." *Id.*

nonpublic information in breach of fiduciary relationships (such as an employee-employer relationship or attorney-client relationship) might be sufficient to create a duty to the buyer or seller of securities.[58] Nevertheless, one possessing such information, absent

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The *Carpenter* court extended this theory, which has been adopted by the Second Circuit and labeled the "misappropriation theory," to include breaches of securities-related duties to the employer who was entrusted with confidential information, not to the injured companies. *See infra* notes 80-145 and accompanying text.

58. *See Chiarella*, 445 U.S. at 235-36; *Misappropriation: A General Theory of Liability, supra* note 2, at 122. Case law, subsequent to *Cady, Roberts* and prior to *Chiarella*, comports with this well-founded principle. Cases such as SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), illustrate the need for a special relationship before a trader has a duty to disclose so as not to violate Rule 10b-5. In *Texas Gulf Sulphur*, the SEC sought to compel the rescission of securities transactions entered into by several officers of the defendant corporation because of a duty to disclose inside corporate information before trading upon it. *See id.* at 839-42. In finding such a duty, the court referred to traditional common law fiduciary concepts. *Id.* at 848. In other words, silence constitutes fraud where there is a duty to disclose because of a fiduciary or other special relationship of trust and confidence between parties to a transaction. *See, e.g.*, Strong v. Repide, 213 U.S. 419, 431 (1909); Diamond v. Oreamuno, 24 N.Y.2d 494, 502, 248 N.E.2d 910, 914, 301 N.Y.S.2d 78, 84 (1969); RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

Since the *Texas Gulf Sulphur* case, other courts have firmly established that nondisclosure amounts to a Rule 10b-5 "manipulative or deceptive device or contrivance" only when such nondisclosure constitutes a breach of a duty to disclose arising out of the special relationship between the trader of the stock, or the original source of the information, and the issuer of that particular stock. *See* Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 279 (2d Cir. 1975) (absent relationship and duty to disclose, nondisclosure of material nonpublic information is not Rule 10b-5 violation); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 890 (2d Cir. 1972) (purpose of Rule 10b-5 is to prevent corporate insiders and their tippees from taking unfair advantage of uninformed outsiders). This well-established principle was clearly delineated in the 1978 Proposed Official Draft of the Federal Securities Code by the American Law Institute. *See supra* note 10. Under the proposed code, nondisclosure may be unlawful in connection with a securities transaction when a person fails to disclose in accordance with such a duty. *See* FED. SEC. CODE § 262 (1978). The ALI proposed code provides, in pertinent part:

> Sec. 1603(a) [*General*] It is unlawful for an insider to sell or buy a security of the issuer, if he knows a [material fact] with respect to the issuer or the security that is not generally available . . . .
>
> (b) . . . "insider" means (1) the issuer, (2) a director or officer of, or a person controlling, controlled by, or under common control with, the issuer, (3) a person who, by virtue of his *relationship* or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question that is not generally available, or (4) a person who learns such a fact from a person specified in section 1603(b) . . . with knowledge that the person from whom he learns the fact is such a person . . . .
>
> Sec. 1602. . . . (a) [*General*] It is unlawful for any person to engage in a fraudulent act . . . in connection with (1) a sale or purchase of a security . . . .

such a relationship, owes no duty to refrain from profiting from his tip.[59]

D. *Dirks: Chiarella* Reiterated and Reaffirmed

In *Dirks v. SEC*,[60] Raymond Dirks, an officer of a New York brokerage firm, received information from a former officer of Equity Funding of America (Equity Funding).[61] The former officer alleged that Equity Funding had engaged in fraudulent business practices.[62] Dirks personally investigated Equity Funding to test these allegations, and in so doing publicized the information he had obtained to various institutions, which then sold their holdings in Equity Funding.[63]

> Sec. 262. . . . (b) Inaction or silence when there is a duty to act or speak may be a fraudulent act.

Id. (emphasis added). The proposed code clearly shows that unless some relationship exists with the corporation whose securities were traded, the person who acquired the information and his tippee are free to use the information to their benefit without potential liability under Rule 10b-5. *See infra* note 59 and accompanying text.

Judge Friendly recognized the need for the existence of such a relationship as a predicate to Rule 10b-5 liability in General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969).

> We know of no rule of law, applicable at the time, that a purchaser of a 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 demands and thus abort the sale.

403 F.2d at 164; *see also* Moss v. Morgan Stanley Inc., 719 F.2d 5, 12 (2d Cir. 1983) (defendant was free to purchase shares of target company prior to announcement of tender offer where he owed no duty of disclosure to target corporation's unwitting shareholder), *cert. denied*, 465 U.S. 1025 (1984); Pacific Ins. Co. v. Blot, 267 F. Supp. 956, 957 (S.D.N.Y. 1967) (failure of defendant outsider to disclose to selling shareholders impending tender offer did not constitute Rule 10b-5 violation); Mills v. Sarjem Corp., 133 F. Supp. 753, 764-65 (D.N.J. 1955) (purchaser of shares had duty to disclose knowledge of future prospects when purchaser held fiduciary position and knowledge was obtained as result of that insider position).

59. *See* Arkin, *Insider Trading—Distinguishing Unequal Advantage from Fraud*, N.Y.L.J., June 19, 1986, at 1, col. 3 [hereinafter *Insider Trading—Distinguishing Unequal Advantage from Fraud*]. The Court's reversal of Chiarella's conviction, based on the nature of the relationship between Chiarella and the corporation upon whose information he traded, comports with these principles. *Chiarella*, 445 U.S. at 237. Chiarella had no duty to corporations in whose securities he traded because he did not share with the corporations the fiduciary relationship necessary for imposing insider liability. *See id.* at 235. For a detailed discussion of the inconsistency between the Supreme Court's decision and the modern trend in the Second Circuit, see *infra* notes 80-100 and accompanying text.

60. 463 U.S. 646 (1983).

61. *See id.* at 648-49.

62. *See id.* at 649.

63. *Id.* at 649-51. The issue in *Dirks* was at what point does a non-corporate insider who receives material nonpublic information, *i.e.*, a "tippee," assume a duty to disclose or abstain from trading. *See id.* at 655.

In sanctioning Dirks, the SEC once again ignored the issue of whether a relationship between Dirks and Equity Funding existed.[64] The Commission declared that when tippees, regardless of their motivation or occupation, come into possession of material nonpublic information that they know is confidential, and when they know, or have reason to know, that such information is coming from a corporate insider, they must disclose the information or refrain from trading on it.[65]

The Supreme Court, expanding upon its holding in *Chiarella*,[66] reiterated the "established doctrine"[67] that a duty is predicated upon the existence of a previously recognized fiduciary duty.[68] Again, the Court emphasized the necessity of a special confidential relationship between the parties, not merely one's ability to acquire and utilize nonpublic inside corporate information because of his position in the marketplace.[69] Recognizing the harmful effects that would result to the securities industry from an overly broad construction of the laws governing insider trading, the Court stressed the need for certainty in the area of insider trading.[70]

Dirks was an expansion of *Chiarella* because, whereas Chiarella received the information by virtue of his position, Dirks was a tippee—who had acquired the information from a corporate insider.[71]

64. *See id.* at 650-51.

65. *See id.* at 651. The United States Court of Appeals for the District of Columbia Circuit affirmed the SEC administrative ruling. 681 F.2d 824, 846 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983). However, the circuit court's opinion was predicated upon a different theory: Dirks, by virtue of his position as a securities analyst associated with a registered broker dealer, acquired a broad disclosure obligation in favor of the public at large. *See Dirks*, 463 U.S. at 665 n.26 (explaining circuit court's analysis). In its majority opinion, the Supreme Court noted that the SEC neither addressed this theory in the administrative case, nor presented it before the court of appeals or the Supreme Court. *See id.*

66. *See supra* notes 44-51 and accompanying text.

67. *See Dirks*, 463 U.S. at 654.

68. *See id.* at 654-55.

69. The Court stressed that 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." *Id.* at 655 n.14.

70. The *Dirks* Court declared that "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." *Id.* at 658; *see also id.* at 658 n.17 (market analysts will be inhibited in their analyses because of their uncertainty as to when line between permissible and impermissible disclosures is crossed).

71. *See id.* at 648-49.

Nevertheless, the Court steadfastly stood by the well established doctrine of insider liability[72] and declared that in determining whether a tippee is liable, the courts must look to the insider from whom the tippee received the information.[73] Because the very core of insider trading liability rests upon the issue of whether a corporate insider has breached a fiduciary duty he owed to the corporation's shareholders,[74] *Dirks* held that only when the tippee participated and knew or should have known of the insider's breach does he acquire a duty to disclose or abstain.[75]

A tippee's duty to the shareholders of a corporation arises only when the insider breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knew or should have known of this breach.[76] The threshold issue then becomes whether the tip constituted a breach of the insider's duty.[77] This question, as *Dirks* pointed out,[78] raises legitimate concerns, because disclosures of confidential corporate information are not necessarily inconsistent with the duty the insider owes to the shareholders.[79]

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72. *See id.* at 656-58.
73. *See id.* at 659.
74. *See id.* at 660-61.
75. *See id.* at 659-61.
76. *See id.* at 660. The Court then compared its holding in *Dirks* with the SEC's ruling in *In re* Investors Management Co., 44 S.E.C. 633 (1971). *See supra* note 38. In *Investors Management*, SEC Commissioner Smith posited the view, consistent with the Court's reasoning in *Dirks*, that the tippee's responsibility must relate back to the insider in order to hold that the tippee has violated a duty to the shareholders of a corporation on the theory that the tippee used information which resulted in a breach of the insider's duty when the insider gave it to him. 44 S.E.C. at 651; *see supra* note 38.

Although the facts in *Dirks* and *Investors Management* are very similar, they also differ significantly which probably accounts for the disparate results reached in these two cases. *Investors Management* involved an administrative proceeding against investment advisors who sold stock in McDonnell Douglas Corporation based on selective disclosure by Merrill Lynch of nonpublic adverse information to institutional investors. Merrill Lynch accepted a sanction and subsequently established a Chinese Wall between its investment banking and brokerage departments to prevent such misuse of inside information. *See* Exchange Act Release No. 8459, [1968 Transfer Binder] Fed. Sec. L. Rep. ¶ 77,629 (Nov. 25, 1968); *see also* Blanc, *Chinese Walls, Tippers, Tippees and Dennis Levine*, N.Y.L.J., June 2, 1986, at 23, col. 1 (possible ramifications of the *Levine* decision on investment banking community). Dirks, however, did not have any fiduciary relationship with Equity Funding vis à vis Merrill Lynch's relationship with McDonnell Douglas Corp. *Dirks*, 463 U.S. at 665. The SEC did not recognize this difference in Dirks' administrative proceeding. *See* 21 S.E.C. No. 1401 (1981).
77. *See Dirks*, 463 U.S. at 661.
78. *See id.* at 661-62.
79. For example, the Court stated that it may not be clear to the insider or recipient financial analyst whether the information is material and nonpublic. *See*

III. The *Chiarella* Dissent and its Ramifications: *Carpenter* and the Misappropriation Theory

The Note will now discuss the misappropriation theory as presented in Chief Justice Burger's *Chiarella* dissent. This will be followed by a discussion of the theory as applied in *United States v. Carpenter.*

A. The *Chiarella* Dissent

Chief Justice Burger's dissent in *Chiarella* presents the misappropriation theory as an alternative theory of liability under Rule 10b-5.[80] The misappropriation theory, a theory that is now law in the Second Circuit,[81] has eliminated the well established principle requiring a duty between the insider and the issuer in whose securities he trades before liability accrues.[82]

The Second Circuit's departure begins with the common law fiduciary duty of an agent to maintain the confidentiality of his principal's secrets and nonpublic proprietary information.[83] Accordingly, an employee may not appropriate for his own benefit his employer's confidential information.[84] When an employee has appropriated confidential information from his employer, he has committed a fraud upon his employer.[85] The misappropriation theory,

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id. at 662. The corporate official may think that certain information has already been disclosed or is not material enough to affect the market. *See id.* In this instance, the Court stated that whether an existing duty has been breached depends on the purpose of the disclosure. *See id.* The test is whether the insider will personally gain from his disclosure. *See id.*

80. *Chiarella*, 445 U.S. at 239-45 (Burger, C.J., dissenting).

81. *See, e.g.,* United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted,* 107 S. Ct. 666 (1986); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied,* 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied,* 464 U.S. 863 (1983).

82. *See supra* notes 35-79 and accompanying text.

83. The Restatement (Second) of Agency states:

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

RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

84. *See id.; see also Carpenter,* 791 F.2d at 1031. The *Carpenter* court stated that it was clear that Winans had breached a duty of confidentiality to his employer by misappropriating confidential prepublished information. *See id.* The court emphasized, however, that the issue was whether such breach served as a predicate for securities fraud. *See id.* at 1028, 1031-32.

85. *See id.* at 1031-33. By misappropriating the information, the court held

as applied in *United States v. Carpenter*,[86] postulates that when the information is securities-related, for example when it concerns a prospective takeover bid or merger of a company and the employee (agent) uses this information for his own personal advantage, the employee's fraud is securities fraud under Rule 10b-5.[87] Thus, the misappropriation theory extends the antifraud provisions of the securities laws to encompass the common law tort of breach by an employee of the duty of confidentiality owed to his employer when the breach is securities-related.

B. *United States v. Carpenter*

R. Foster Winans, a reporter for *The Wall Street Journal*, was a co-author of the *Journal*'s column, "Heard on the Street."[88] This column was basically a collection of the opinions of Wall Street analysts regarding the movements and prospects of particular securities.[89] The column was widely read and influential, and thus tended to have short-term influences[90] upon the value of the securities which were discussed.[91]

The district court found that Winans received $30,000 from his co-defendants for systematically providing them with information regarding the content and timing of about twenty-seven "Heard on the Street" articles.[92] Winans and his co-defendants used this information to their benefit.[93] By trading on the basis of their advance

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that Winans " 'stole, to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence.' " *Id.* at 1031 (quoting *Chiarella*, 445 U.S. at 245) (Burger, C.J., dissenting)). In fact, Chief Justice Burger would have had the provisions of section 10(b) and Rule 10b-5 "reach *any* person engaged in *any* fraudulent scheme." 445 U.S. at 240 (Burger, C.J., dissenting) (emphasis in original); *accord Carpenter*, 791 F.2d at 1032 (because rule says fraud and deceit upon any person, it was sufficient that fraud was committed upon Winans' employer).

86. *See Carpenter*, 791 F.2d at 1031-36.

87. *See id.* at 1031; *see also Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting). This reasoning would fit in well within Rule 10b-5 if the rule is read literally. The rule encompasses "any act . . . which operates or would operate as a fraud or deceit . . . in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1987). The repeated use of the word "any" led the *Carpenter* court to believe Congress intended such a broad reading of the rule. *Carpenter*, 791 F.2d at 1029-30.

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

89. *See id.*

90. *See id.* at 1026; *infra* note 95 and accompanying text.

91. *See supra* note 90.

92. *See* United States v. Winans, 612 F. Supp. 827, 834 (S.D.N.Y. 1985), *aff'd in part; rev'd in part sub nom.* United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986).

93. *See Carpenter*, 791 F.2d at 1026-27.

knowledge of the content of the column and the timing of its publication, the defendants netted profits of approximately $700,000.[94] This practice by financial reporters is known as "scalping"—using advance knowledge of the timing and substance of articles to trade in securities or enabling others to do so.[95]

During November, 1983, the Compliance Department of Kidder, Peabody & Co., Inc. discovered a correlation between the trading of securities in the account of Kenneth Felis, a Kidder, Peabody employee, and some of the securities discussed in "Heard on the Street."[96] Upon questioning by a Kidder, Peabody supervisor, Felis denied any impropriety.[97] Felis then reallocated certain funds among various trading accounts to conceal his continued operation in the scheme.[98] The scheme was uncovered by an ensuing SEC investigation, however, when Felis' co-conspirators, Carpenter and Winans, voluntarily testified on March 29, 1984 about the scheme.[99] In 1985, the district court found Felis, Carpenter and Winans guilty of misappropriating material nonpublic information from the *The Wall Street Journal* in connection with the purchase and sale of securities.[100]

In asserting that their conduct could not serve as a predicate for securities fraud liability, the defendants distinguished their case from the two previous applications by the Second Circuit of the misappropriation theory:[101] *United States v. Newman*[102] and *SEC v. Materia*.[103]

In *Newman*, employees of the investment banking firms of Morgan Stanley & Co. and Kuhn Loeb & Co. received material nonpublic information entrusted to their employers by corporate clients con-

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94. *See id.*

95. *See Financial Reporters, supra* note 2, at 1037; *see also* Peskind, *Regulation of the Financial Press: A New Dimension of Section 10(b) and Rule 10b-5*, 14 St. Louis U.L.J. 80, 81 (1969); *see, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 181 (1963) (scalping is process whereby investment advisor purchases securities for his own account, recommends securities to his client, then sells his securities following recommendation); Zweig v. Hearst Corp., 594 F.2d 1261, 1265 (9th Cir. 1979) (scalping described as practice of purchasing securities shortly before publication of columns concerning companies, then selling after columns published caused jump in price).

96. *See Carpenter*, 791 F.2d at 1027.

97. *See id.*

98. *See id.*

99. *See id.*

100. *See* United States v. Winans, 612 F. Supp. at 849-50.

101. *See Carpenter*, 791 F.2d at 1028-29.

102. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

103. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

cerning prospective tender offers.[104] Newman, a broker, conspired with two foreign citizens to purchase stock in companies that were merger or acquisition targets of the firms' clients by using secret foreign accounts.[105]

In *Materia*, an employee of a financial printer was able to decipher the identities of tender offer targets from documents regarding proposed tender offers.[106] Within hours of each such discovery, Materia purchased stock in the target company and then sold his holdings for substantial gains after information of the proposed tender offers became public.[107] In both *Newman* and *Materia*, the Second Circuit held that these misappropriations of information constituted a fraud upon the defendants' employers by damaging their employers' reputations.[108] These fraudulent acts, the court held, served as the predicate for securities fraud violations within the realm of Rule 10b-5.[109]

The defense in *Carpenter* argued that *Newman* and *Materia* were factually distinguishable from *Carpenter*.[110] In both *Newman* and *Materia*, the material nonpublic information was misappropriated by employees who had a duty of confidentiality not only to their employers, but also to their employers' clients.[111] This latter duty,

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104. *See Newman*, 664 F.2d at 15.

105. *See id.*

106. *See Materia*, 745 F.2d at 199.

107. *See id.*

108. *See Newman*, 664 F.2d at 17; *see also Materia*, 745 F.2d at 202. In *Newman*, the court ruled that by their actions, the conspirators injured Morgan Stanley and Kuhn Loeb's reputations, and defrauded them "as surely as if they took their money." 664 F.2d at 17. In *Materia*, the court held that the defendant defrauded his employer by damaging "its reputation as a safe repository for clients' secrets." 745 F.2d at 202.

109. *See Materia*, 745 F.2d at 203; *Newman*, 664 F.2d at 19.

110. *See Carpenter*, 791 F.2d at 1028-29. The court criticized the appellants' argument, saying that it suggested that it was not enough that Winans breached his duty of confidentiality to his employer; "he would have to have breached a duty to the corporations or shareholders thereof whose stock they purchased or sold on the basis of that information." *Id.* at 1029.

111. *See id.* at 1028-29. Although the *Newman* and *Materia* courts found that the reputations of the employers were harmed by the misappropriation of confidential information by their employees, the injuries alone were not enough to sustain violations under the securities laws. *See Materia*, 745 F.2d at 202; *Newman*, 664 F.2d at 17. Ultimately, application of the securities laws turned on the duty that existed between the employees and the employers' clients. *See Materia*, 745 F.2d at 202; *Newman*, 664 F.2d at 17-18. The *Newman* concurrence/dissent recognized the lack of a duty between the defendants and the companies in whose securities they traded: "Though they deceptively and improperly violated a fiduciary duty to their employers and customers of their employers, those parties had not at that time actually purchased or sold any target company securities." *Id.* at 20 (Dumbauld,

according to the defense, was not present in *Carpenter*.[112]

The *Carpenter* defendants were attempting to invoke the long-standing requirement that to violate the securities laws' antifraud provisions, one must breach a fiduciary duty to the company concerning whose information he trades.[113] Thus, prior to *Carpenter*, the misappropriation theory applied to cases in which the employee had traded on the basis of material nonpublic information acquired from his employer to whom he owed a fiduciary duty to protect the confidential information given his employer by corporate clients. Winans may have breached his duty of confidentiality to his employer, *The Wall Street Journal*; however, this Note asserts that Winans, unlike the defendants in *Newman* and *Materia*, did not breach a duty of confidentiality to the corporations concerning whose information he traded. He would have breached such a duty if, when he traded in a company's securities, he possessed material nonpublic information concerning the company. As the district court found, "Winans was not a temporary insider [of the corporations he wrote about in his column], did not owe any duty to the corporations he wrote about, and was not a tippee of any corporate inside information."[114]

Thus, the Second Circuit holding was directly contrary to *Chiarella*, in which the Supreme Court explicitly held that when a noncorporate insider, such as Winans, cannot be considered a fiduciary to the persons with whom he traded, no duty of disclosure exists.[115] Furthermore, as in *Dirks*, the securities-related information involved was assembled by Winans through his own analytical skills. Also,

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J., concurring and dissenting). Senior District Judge Dumbauld, however, concurred in reversing the dismissal of the defendant's indictment because the defendant clearly violated the mail fraud statute in his explicit scheme to defraud. *Id.* at 20-21 (Dumbauld, J., concurring and dissenting); *see also* 18 U.S.C. § 1341 (1982).

112. The defense argued that in *Newman* and *Materia*, the employer had the same duty of confidentiality to the corporations as did the employee, while Winans and the Wall Street Journal had a completely different status vis à vis the corporations in whose securities Winans traded. *See* Brief for Defendant-Appellant R. Foster Winans at 18-19, United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986). This argument, presented to the court by the defense, illustrated the difference between Winans and the Wall Street Journal in trading on the subjects of Winans' column. See *infra* note 133 for a discussion of the result in distinguishing Winans from the *Journal*.

113. *See supra* note 35 and accompanying text.

114. 612 F. Supp. at 841. The district court continued, stating that "[i]n terms of the securities laws, neither Winans nor the Wall Street Journal owed any duties at all to the corporations that were the subject of *Heard* [*on the Street*] columns or to the shareholders of those corporations." *Id.*

115. *See supra* notes 44-59 and accompanying text.

the employer in this case, *The Wall Street Journal*, was a newspaper and had no duty of disclosure to the corporations appearing in Winans' column.[116]

Nonetheless, the Second Circuit rejected the defense's argument by finding their reading of the misappropriation theory, as expounded in *Newman* and *Materia*, too restrictive.[117] In resuming where it had left off in *Materia*,[118] the court further widened the scope of insider liability, continuing its deviation from the *Chiarella* guidelines[119] and held the theory to encompass misappropriation by insiders "*or others*"[120] of material nonpublic securities related information.[121]

In sum, the *Carpenter* holding rests upon an expansion of the misappropriation theory to encompass the common law tort of breach of the duty of confidentiality to an employer. Allowing the web of Rule 10b-5 to expand exponentially as in *Carpenter*, the courts have expanded the notion of trading upon inside information beyond the purview of *Dirks* and *Chiarella*.[122]

IV. Securities Laws Protection: Employer/Employee Duties and Internal Corporate Policy

The implications of a misappropriation theory are two-fold: not only will an employee who uses confidential securities-related information obtained from his employer be liable under Rule 10b-5, but a third party—one owing no fiduciary duty to the corporation—

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116. The *Carpenter* court did not have to reach the question of whether trading based upon advance knowledge of the contents of an upcoming issue of a financial publication, without of a breach of a fiduciary duty, was actionable under the antifraud provisions of the securities laws. *See Carpenter*, 791 F.2d at 1033 n.10.

117. *See id.* at 1029.

118. *See Materia*, 745 F.2d at 203 (liability will not arise merely because one "misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage").

119. *See supra* notes 44-59 and accompanying text.

120. *Carpenter*, 791 F.2d at 1029 (emphasis in original).

121. The *Carpenter* court, in broadly construing the theory, relied upon the language used in *Materia*, requiring merely that a person " 'misappropriates nonpublic information in breach of a fiduciary duty and trades on that information' . . . . [S]ection 10(b) was not 'aimed solely at the eradication of fraudulent trading by corporate insiders.' " *Id.* at 1029 (quoting *Materia*, 745 F.2d at 203, 201). In order to bring breach of the common law employer/employee duty within the ambit of Rule 10b-5, the court stressed that the rule prohibits "any person . . . [from engaging in] any act . . . which operates as a fraud or deceit upon any person." *Id.* at 1029-30; *see also* 17 C.F.R. § 240.10b-5 (1987). This literal interpretation is clearly inconsistent with Congressional intent behind the statute. *See infra* notes 126-32 and accompanying text.

122. *See supra* notes 44-79 and accompanying text.

who obtains material nonpublic information for the purpose of trading upon that information will also be liable under Rule 10b-5.[123] This liability clearly conflicts with the intended purpose of the antifraud provisions of the securities laws.[124]

At common law, an employee owes a duty of confidentiality to his employer regarding material nonpublic information in his employer's possession.[125] In the event the employee breaches this duty (for example, by misappropriating confidential information), the employer has a remedy.[126] *Carpenter* held that as a result of Winans' breach of duty to his employer, Winans was under a corollary duty to disclose or to abstain from trading on the basis of this misappropriated information.[127] The only duty Winans violated was his duty to his employer.[128] Furthermore, the court did not base this violation on the well established common law principle of fiduciary relationship between an employer and an employee,[129] but rather on internal corporate policy.[130] The court found misappropriation because as a matter of its own corporate policy, Winans' employer, *The Wall Street Journal*, told its employees at the end of a lengthy policy manual that information regarding the *Journal*'s activities was confidential.[131]

123. The Second Circuit's line of reasoning would also give rise to liability when a third party with no fiduciary relationship purloins confidential information from a corporation and trades on it. *See Carpenter*, 791 F.2d at 1032; *Insider Trading—Distinguishing Unequal Advantage from Fraud, supra* note 59, at 4, col. 2. In *Carpenter*, the Second Circuit's requisite of fraud existed and since this fraud arose in connection with the purchase or sale of securities, it was securities fraud. *See Carpenter*, 791 F.2d at 1032.

124. *See supra* notes 51-79 and accompanying text.

125. *See supra* note 83.

126. *See id.* The general tort of breach of a duty of confidentiality to an employer is well-settled. *See, e.g.*, Frank v. Wiltscheck, 209 F.2d 493, 495 (2d Cir. 1953).

127. *Carpenter*, 791 F.2d at 1034.

128. *See id.* at 1028; *supra* notes 113-14 and accompanying text.

129. *See Carpenter*, 791 F.2d at 1033-34.

130. *See id.* In *Carpenter*, the Wall Street Journal policy, which included a variety of topics, provided that employees should not buy or sell stocks in anticipation of articles they know will appear and should not disclose the subjects of upcoming articles to outsiders. *See* Brief for Defendant-Appellant R. Foster Winans at 5, United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986).

131. *Carpenter*, 791 F.2d at 1026, 1033-34. When an employee purloins information entrusted to his employer by a client, the employer's reputation for confidentiality to his clients is injured. *See id.* at 1033; *Materia*, 745 F.2d at 202. But the damage to the employer's reputation for confidentiality that seemed to be the sole basis for the securities violation in *Carpenter* was not enough to sustain a Rule 10b-5 violation under the misappropriation theory as applied in *Newman* and *Materia*. *See supra* note 111. It was the duty to the employers' clients in *Newman*

Carpenter acknowledged that if it were not for the *Journal's* policy, there would have been no securities violation.[132] The intended purposes of the securities laws, however, are not served by applying them to situations such as the one presented in *Carpenter*.[133] The

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and *Materia* which supported a finding of securities law violations, not merely the injury of the employers' reputation for confidentiality. *See id.* In *Carpenter*, it is arguable that the reputation of the Wall Street Journal was undamaged because its policy of confidentiality was not disclosed to the general public until after the commencement of the *Carpenter* case. *See* Obermaier, *supra* note 1, at 2, col. 3.

132. *Carpenter*, 791 F.2d at 1033-34. The court held that "because of [their] duty of confidentiality to the *Journal*, defendant[s] . . . had a corollary duty, which they breached, under section 10(b) and Rule 10b-5 . . . ." *Id.* at 1034.

133. The Second Circuit's adoption of the misappropriation theory based upon the facts of *Carpenter* raises several questions. First, one purpose of the federal securities laws is to protect the integrity of the securities industry. *See supra* note 21. In contrast, the defendant in *Carpenter* was not in the securities industry, but was a journalist, and the only business relationship he had was with his readers. *See Carpenter*, 791 F.2d at 1026. The information that Winans put together concerning the corporate subjects of his column could only be attributed to his analytical skills as a financial reporter. *See Insider Trading—Distinguishing Unequal Advantage from Fraud, supra* note 59, at 4, col. 2; *see also* United States v. Winans, 612 F. Supp. 827, 830 (S.D.N.Y. 1985), *aff'd in part; rev'd in part sub nom.* United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986). Second, the court recognized that there would have been no securities violation by the Wall Street Journal if the newspaper company itself had traded on the same information. *Carpenter*, 791 F.2d at 1033-34. Strangely, neither Winans nor the Wall Street Journal had a fiduciary duty to the subjects of the column but one will be liable under the securities laws for trading on the basis of information about the subjects of the column. *See* Obermaier, *supra* note 1, at 2, col. 3. Furthermore, if the *Journal* could trade and the columnist could not trade because of policy reasons addressed to the concerns of the securities markets, the impact is irrelevant from the perspective of the investor. Because of the impersonal nature of the New York Stock Exchange, in which one cannot tell the difference between the buyers and sellers, the investing public is no more protected by the misappropriation theory as applied here. *See id.* at 2, col. 4. The average investor has no idea that a newspaper columnist is prohibited by the newspaper's policy from trading in advance on information contained in his column nor is it likely that he knows Rule 10b-5 exists. In addition, it would not appear to matter to the buyers and sellers of the securities contained in Winans' column whether the transactions were made by Winans or his employer. Accordingly, in a Third Circuit case which involved a similar misappropriation, *Rothberg v. Rosenbloom*, Judge Higginbotham, in his concurrence, recognized that as to the insiders who traded on the basis of nonpublic information of a corporation for the benefit of their joint venture, it made no difference to the investing public whether they had traded upon such information on behalf of the corporation or on behalf of the joint venture. 771 F.2d 818, 824 (3d Cir. 1985) (Higginbotham, J., concurring), *cert. denied*, 107 S. Ct. 1895 (1987). For the purposes of Rule 10b-5, "this is a difference that makes no difference." *Id.* at 825 (Higginbotham, J., concurring). Judge Higginbotham concurred that Rule 10b-5 applied, but under a different theory, that insiders fit into the rule as "tippees" under a *Dirks* approach. *Id.* at 825-26 (Higginbotham, J., concurring). He recognized that the majority merely attempted to force the case under the Third Circuit's newly adopted "misappropriation or breach-of-fiduciary-duty-to-a-third-person theory." *Id.* (Higginbotham, J., concurring).

misappropriation theory, therefore, is not related to the purposes of the Exchange Act and involves federal enforcement of a common law duty to an employer rather than regulation of the securities markets.

Taking an overly broad view of the insider's duty calls into question the applicability of the insider trading laws to arbitrageurs.[134] In light of *Dirks*' holding that not all trading upon material nonpublic information constitutes an insider trading violation, and in light of the strong public interest recognized by *Dirks*, which in effect encourages access to information by marketing analysts,[135] adopting a broad application of the insider trading laws misconstrues the antifraud provisions' very applicability.[136] A wealth of information is available to arbitrageurs that is not generally available to most investors.[137] This information becomes available to arbitrageurs when they merely perform in the way they have been trained. It would be unjust for the courts to assume that an insider violation or conspiracy has occurred every time an arbitrageur has obtained material information unknown to the public at large.[138]

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134. *See Insider Trading—Distinguishing Unequal Advantage from Fraud, supra* note 59, at 4, col. 1. An arbitrageur is one who trades in different markets, purchasing a security in one and selling in another hoping to profit from the price discrepancies in the markets. *See* BLACK'S LAW DICTIONARY 95 (5th ed. 1979). If, for example, ABC stock could be bought in New York for $10 a share and sold in London at $10.50, an arbitrageur may simultaneously purchase ABC stock in New York and sell the same amount in London, making a profit of 50 cents per share.

135. *See Dirks*, 463 U.S. at 658-59.

136. There are instances where trading on nonpublic information is lawful. *See, e.g., Leveraged Buyout, supra* note 25, at 718 (alleging insider conspiracy when management acts on inside information in management buyout transaction, while having certain conspiratorial appeal, overlooks practical aspects of transaction). A director of enforcement for the SEC stated that " 'if an investor has reason to suspect—only suspect—that a stock tip is based on private corporate information and that the stock price would be affected if the public knew about it, it would probably be illegal for him to trade in the stock.' " N.Y. Times, Nov. 23, 1986, News of the Week in Review, at 5, col. 4 (quoting Gary Lynch). This reasoning contradicts the Supreme Court and common view of what type of securities trading is legally permissible. *See supra* notes 39-79 and accompanying text. It is arguable whether any securities trading would take place in a marketplace which has available only the formal public filings of corporate issuers. While the insider trading panic affecting the securities markets has led to acceptance in the Second Circuit of the SEC director's previously quoted reasoning, the Supreme Court has stated and reaffirmed in *Chiarella* and *Dirks* its more realistic opinion of what actions should be characterized as unlawful insider trading. *See id.*

137. *See infra* note 138.

138. *See Insider Trading—Distinguishing Unequal Advantage from Fraud, supra* note 59, at 4, col. 2. Arbitrageurs have information which, as a practical matter, is not available to most investors: "computerized scanning of the tape, SEC filings,

Advocates of the misappropriation theory assert that courts should interpret Rule 10b-5 according to its plain meaning: "fraud or deceit . . . in connection with the purchase or sale of any security."[139] Under the theory, however, the analysis of the duty requirement implemented by courts is far from plain.[140] *Chiarella* made clear that a duty to disclose or refrain from trading "arises from the relationship between parties."[141] The Supreme Court has explicitly rejected the principle that the securities laws were intended to ensure equality of information in the securities markets, or that buyers and sellers of securities owe a general duty to the marketplace.[142] Moreover, in *Sante Fe Industries, Inc. v. Green*,[143] the Supreme Court held that Rule 10b-5 violations are not made out by "all breaches of fiduciary duty in connection with a securities transaction."[144] Certainly, a Rule 10b-5 violation should not be found because a private company imposed a duty by way of implementing internal policy designed to protect its reputation and that duty has been breached.[145]

In *Carpenter*, the Second Circuit has deviated from Congress' purpose in enacting Rule 10b-5.[146] Congress enacted the securities acts to protect the investing public and to preserve market integrity, not to regulate the employer/employee duties which have long been regulated by the common law.[147] The Second Circuit's expansive reading of Rule 10b-5 is an understandable response to the growing problem of insider trading.[148] Nevertheless, the question remains

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careful reading of the financial press, . . . attendance at analysts' meetings, lawful knowledge as to who is buying or selling any particular securities." *Id.*

139. 17 C.F.R. § 240.10b-5 (1987). For a discussion of the applicability of the literal language of Rule 10b-5, see *supra* note 129.

140. *See supra* notes 101-22 and accompanying text.

141. *Chiarella*, 445 U.S. at 231 n.14.

142. *See id.* at 233; *Dirks*, 463 U.S. at 657-58.

143. 430 U.S. 462 (1977).

144. *Id.* at 472. The Second Circuit expressly rejected the principle of "duty in the air." Moss v. Morgan Stanley, Inc., 719 F.2d 5, 13 (2d Cir. 1983) (quoting Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347, 1353 (S.D.N.Y. 1983)), *cert. denied*, 465 U.S. 1025 (1984).

145. At the district court level in *Carpenter*, the court conceded that if not for the violation of the Wall Street Journal policy, the petitioners would not have violated the securities laws. United States v. Winans, 612 F. Supp. at 842. As noted in the petition for certiorari to the United States Supreme Court, the Wall Street Journal policy specifically represented that Wall Street Journal employees went well "beyond the requirements of the law" by adhering to such policy. Petition for Writ of Certiorari to the United States Court of Appeals for the Second Circuit at 7, Carpenter v. United States (No. 86-422 Oct. Term 1986).

146. *See supra* notes 14-16 and accompanying text.

147. *See supra* notes 18-22 and accompanying text.

148. *See supra* note 1.

whether this response is justified. The answer to this question requires a brief reflection on the role of courts in our society.

Justice Frankfurter, in his article on the intricacies of reading statutes, used the teachings of the great masters in the art of interpretation as his guide: Holmes, Brandeis and Cardozo.[149] These Justices remembered that statutes are "expressions of policy . . . addressed to the attainment of particular ends."[150] Judges are confined to their judicial function, which is to ascertain the meaning of words used by the legislature.[151] "To go beyond it is to usurp a power which our democracy has lodged in its elected legislature."[152] Judges must avoid whatever temptations they might have to legislate policy when construing a statute.[153] Consistent with statutory language

149. Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527 (1947) [hereinafter *Reflections*].

150. *See id.* at 533.

151. *See* E. CRAWFORD, CONSTRUCTION OF STATUTES 245-46 (1940) (only legitimate object of construction is to ascertain intent of legislature and to give it effect) [hereinafter CRAWFORD].

152. *Reflections*, *supra* note 149, at 533.

153. It is essential that the judiciary know its bounds:

> The vital difference between initiating policy . . . and merely carrying out a formulated policy, indicates the relatively narrow limits within which choice is fairly open to courts and the extent to which interpreting law is inescapably making law. To say that . . . courts make law just as do legislatures is to deny essential features in the history of our democracy. It denies that legislation and adjudication have had different lines of growth, serve vitally different purposes, function under different conditions, and bear different responsibilities.

Id. at 534. Justice Traynor recognized these constraints in his lecture on statutory construction:

> The court itself cannot be the engine of social reform. The very responsibilities of a judge as an arbiter disqualify him as a crusader. . . . Unlike the legislator, whose lawmaking knows no bounds, the judge stays close to his house of the law . . . . A judge is constrained by training, experience, and the office itself, not to undertake responsibilities that belong to the legislature.

R. Traynor, Murray Lecture at the University of Iowa College of Law, March 31, 1977, *reprinted in* 3 J. SUTHERLAND, STATUTORY CONSTRUCTION 265-74 (4th ed. rev. 1984).

If courts were permitted to ignore legislative intent or statutory language, they would invade the province of the legislature and violate this country's tri-partite theory of government. CRAWFORD, *supra* note 151, at 245; T. SEDGWICK, STATUTORY CONSTRUCTION 252-53 (2d ed. 1980) [hereinafter SEDGWICK]. The legislature would become a nonentity and the courts would make the laws. CRAWFORD, *supra* note 151, at 245. Recently, the Supreme Court declared that where there is " 'clearly expressed legislative intention' contrary to [the enactment's] language," the Court must "question the strong presumption that Congress expresses its intent through the language it chooses." I.N.S. v. Cardozo-Fonesca, 107 S. Ct. 1207, 1213 n.12 (1987) (quoting Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc., 447 U.S.

and legislative history, a statute must be applied pursuant to the purpose for which Congress enacted it.[154] Section 10(b) was not intended to be the great protector of internal corporate policy or of employer/employee common law duties.[155]

Justice Cardozo stated that the meaning of statutes must be searched for in "relation to the end in view."[156] "In a democracy the legislative impulse and its expression should come from those popularly chosen to legislate, and equipped to devise policy, as courts are not."[157] An argument that Congress' purpose in enacting section 10(b) should be responsive and expanded to encompass the growing concerns of insider trading is a principle that has been expressly rejected.[158] Judges are not to delve into the minds of legislators or committee members in ascertaining the subjective design of a statute to accommodate growing concerns of modern society.[159] The purpose given to a statute is not one which Congress "would" have enacted, rather, it is that which it "did" enact.[160]

102, 108 (1980)).

Unless judicial authority is carefully exercised, the boundary between the legislature and judiciary would disintegrate and the law-making power would fall to the branch of government which was not intended to have any share in the enactment of laws. SEDGWICK, *supra*, at 19. Unless a line drawn between the legislature and judiciary is clearly marked and strictly maintained, "jurisprudence will always fall short of the scientific character to which it aspires." *Id.* at 184.

154. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 200 (1976).

155. *See supra* notes 124-45 and accompanying text.

156. Panama Ref. Co. v. Ryan, 293 U.S. 388, 433, 439 (1935) (Cardozo, J., dissenting).

157. *Reflections*, *supra* note 149, at 545.

158. *See infra* note 159 and accompanying text.

159. Against what he believed to be such an attempt, Justice Cardozo once protested:

> The judgment of the [C]ourt, if I interpret the reasoning aright, does not rest upon a ruling that Congress would have gone beyond its power if the purpose that it professed was the purpose truly cherished. The judgment of the [C]ourt rests upon the ruling that another purpose, not professed, may be read beneath the surface, and by the purpose so imputed the statute is destroyed. Thus the process of psychoanalysis has spread to unaccustomed fields.

United States v. Constantine, 296 U.S. 287, 298-99 (1935) (Cardozo, J., dissenting).

160. *Reflections*, *supra* note 149, at 539. Much has been written on the art of interpreting and construing statutes beyond that covered in this Note. Whenever a court engages in statutory interpretation, it exercises judgment that may affect the outcome and thus make law contrary to the American jurisprudential perception of the separation of powers. *See* Abrams, *The Place of Procedural Control in Determining Who May Sue or Be Sued: Lessons in Statutory Interpretation from Civil RICO and* Sedima, 38 VAND. L. REV. 1477, 1490-1506 (1985). A court must be careful not to exceed its bounds and enter the realm of the legislature. *See id.*

V. Conclusion

The misappropriation theory is not consistent with the statutory purposes of the Exchange Act. It involves federal enforcement of a common law duty to an employer rather than regulation of the securities markets. The Supreme Court has limited the scope of section 10(b) and Rule 10b-5 to cases in which corporate insiders—or those with whom they are privy—breach fiduciary duties by trading on material information not available to the shareholders of the corporation in whose securities they trade. *Chiarella* stated, and *Dirks* reiterated, the long-standing requirement established by *Cady, Roberts*—Rule 10b-5 applies only when there is "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[161] In *Carpenter*, no such relationship or duty existed between Winans and the sources of his information. Unless one reads a party of information requirement—rejected by *Chiarella* and *Dirks*—into section 10(b) and Rule 10b-5, this extension of the securities laws to the conduct in *Carpenter* has no basis.

The kind of judicial legislation engaged in by the Second Circuit in *Carpenter* is inappropriate. Admittedly, the recent and growing concerns in the area of insider trading mandate action by the SEC to promulgate rules setting new policy to accommodate these concerns. Extending the Exchange Act in its present state to accommodate these growing concerns, however, was not the intent of Congress in enacting such legislation. To do so would subvert an act of Congress, thereby impairing congressional supremacy in substantive policymaking.

Elliot Brecher

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161. *Chiarella*, 445 U.S. at 230.