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INSIDERS, OPTIONS AND THE FIDUCIARY PRINCIPLE: A RULE 10b-5 LOOPHOLE

I. Introduction

Insider trading has long been associated with the American securities markets. Corporate insiders who learn of material financial information about their company before it is available to the investing public can earn substantial profits by trading securities on that information. Although insider trading is unlawful, and has been widely condemned as unfair and destructive to the fair operation of the securities markets, the practice continues.


2. Briefly, information is material if there is a substantial likelihood that a reasonable investor would consider it important in deciding his choice of action in a particular securities transaction. See Basic Inc. v. Levinson, 56 U.S.L.W. 4232, 4234 (U.S. Mar. 7, 1988).


4. See id. at 2295.

5. See infra notes 40-56 and accompanying text.


The recent surge of corporate takeovers has exacerbated the problem by creating frequent opportunities for insiders to profit by trading on nonpublic information regarding pending takeover attempts.\(^7\) Insider traders reap substantial gains at the expense of investors who trade securities without the benefit of the undisclosed information.\(^8\) Many of these investors trade stock, others, however, trade stock options.\(^9\) Both groups of investors may ultimately attempt to recoup

7. See Rogers, Leaders of Congress Doubt Boesky Case Will Force Major New Trading Curbs, Wall St. J., Nov. 19, 1986, at 2, cols. 1, 2 (according to Senator Howard Metzenbaum, "[t]akeover mania has spawned widespread abuses"). The House report drew the following conclusion:

Insider trading on United States securities markets is a serious problem, especially in connection with tender offers. One reason is that the prospect of enormous profits is a powerful lure. Another is the public perception that the risk of detection is relatively slight. Moreover, Wall Street’s current merger wave creates countless opportunities for insider trading. Because tender offerors typically offer substantial premiums over the prevailing market price of the subject company’s securities, anyone knowing of an imminent tender offer can acquire substantial profits while incurring essentially no economic risk.


8. See, e.g., Hertzberg, Boesky May Get Substantial Tax Break From Part of Settlement, Experts Say, Wall St. J., Nov. 21, 1986, at 2, cols. 1, 2 (Wall Street stock speculators believe violator’s insider trading profits exceeded $100 million settlement with United States government); A Chronology of the Wall Street Scandal, Wall St. J., Feb. 13, 1987, at 10, col. 2 (between May 12 and July 1, 1986, Securities and Exchange Commission charged three investment bankers with making profits ranging from $120,000 to $12.6 million from insider trading) [hereinafter Chronology].


One commentator has noted, "[t]rading in [options] is particularly subject to abuse of inside information because it provides opportunity for large gains relative
their losses by suing the insider traders under section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 promulgated thereunder.

The Exchange Act does not expressly prohibit trading on material nonpublic information by insiders, yet its history suggests that the prohibition of insider trading was an important purpose behind its enactment. Likewise, Rule 10b-5 contains no express prohibition against insider trading. Nonetheless, the Rule has become the primary vehicle for imposing both civil and criminal sanctions against insider traders.

The prohibition against insider trading is embodied in the "disclose or abstain" rule—certain persons with knowledge of material nonpublic information about an issuer's securities must either disclose that information or abstain from trading in those securities. The

to the small amount of investment at risk." Note, Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain, 73 Calif. L. Rev. 483, 506-07 (1985) [hereinafter Corporate Recovery]. For further discussion of option trading, see infra notes 182-207 and accompanying text.

10. See Miller & Power, Boesky Case Expected to Bring Windfall For Lawyers From Suits Claiming Losses, Wall St. J., Nov. 21, 1986, at 2, col. 1. "The Ivan F. Boesky case has brought horrendous losses for some stock market speculators . . . . Plaintiffs' lawyers are expected to file a blizzard of suits on behalf of investors claiming they suffered losses because of Mr. Boesky's insider trading." Id. Attorneys agree that the litigation stemming from recent insider trading activities will be massive and widespread. See id. at 10, col. 2.

11. 15 U.S.C. § 78j (1982). For the text of § 10(b) and further discussion regarding its application to insider trading cases, see infra notes 33-181 and accompanying text.

12. 17 C.F.R. § 240.10b-5 (1987). Rule 10b-5 has been used to impose criminal and civil penalties against insider traders, as well as to allow private recovery. For the text of Rule 10b-5 and a discussion of its application to insider trading cases, see infra notes 35-181 and accompanying text.


15. See Corporate Recovery, supra note 9, at 487; see also 17 C.F.R. § 240.10b-5 (1987).


17. See Texas Gulf Sulphur, 401 F.2d at 848. For further discussion of the rule's development, see infra notes 113-25 and accompanying text.
duty to disclose or abstain is not imposed on every possessor of material nonpublic information. Rather, the duty arises only when there is "a fiduciary or other similar relation of trust and confidence" between the parties to a transaction. This concept, known as the "fiduciary principle," was established by the Supreme Court in Chiarella v. United States.

Chiarella involved insider trading in equity securities, or corporate stock. Insiders, however, may also trade non-equity securities such as stock options. In at least one scenario in the options context, the fiduciary principle leaves an insider trading loophole. For example, investors will often hold stock options without owning any shares of the underlying stock. Assume an option holder trades his option to buy stock, a call option, on an impersonal market, to an insider of the issuer of the underlying securities.

19. Langevoort, supra note 6, at 3.
21. See id. at 224. The fiduciary principle tends to limit Rule 10b-5 liability. See infra notes 113-45 and accompanying text for a discussion of developments in insider trading law prior to the Chiarella decision. The principle does not, however, allow an insider who trades stock without disclosing inside information to escape criminal liability, nor does it affect a defrauded shareholder's right to recover from an insider trader. Whenever an insider trades shares of his company's stock on material nonpublic information without disclosing that information to the trading shareholder, he has committed a fraud within the meaning of Rule 10b-5. The insider shares a fiduciary relationship with all equity shareholders of the company, for all shareholders have an ownership interest in the company. See O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1184 (S.D.N.Y. 1981). The insider's fiduciary duty gives rise to a separate duty either to disclose or to abstain from trading on material nonpublic information. See Chiarella, 445 U.S. at 228-29. His silence concerning inside information in connection with a trade of shares constitutes fraud, and he will be subject to both criminal and civil liability under Rule 10b-5. Id.


22. See supra note 9 and accompanying text for a discussion of insider trading in options.
23. "[T]he option [holder] need not own any shares of the issuer of the underlying security." Langevoort, supra note 6, at 41.
24. It is important to note that a face-to-face transaction may create a relationship
INSIDER TRADING

The insider is in possession of material nonpublic information. The information is later disclosed and the price of the underlying stock rises far above the fixed exercise price of the call option. The insider exercises the option and resells the stock at a large profit.

Because the option trader does not share a fiduciary relationship with the insider, the insider has no duty to disclose material nonpublic information to the option trader. Accordingly, under Chiarella, the insider is neither criminally liable nor liable for damages under Rule 10b-5.

A reasonable interpretation and application of the principles derived from the line of cases culminating in Chiarella, however, would preclude such a loophole, and the insider would be subject to either criminal or civil liability or both. Some courts, in accordance with the policy of maintaining fair markets which underlies the Exchange Act, distinguish Chiarella in order to close this options loophole. Other courts, however, adhere strictly to the fiduciary principle and thus cannot effectively police informational abuses connected to option trading.

This Note analyzes transactions involving the purchase and sale of option contracts by an insider possessing material nonpublic information to determine whether the insider violates section 10(b) or Rule 10b-5. Part II of the Note presents an overview of the framework of Rule 10b-5 and, in particular, its enforcement in insider trading cases. Part III examines the differing views espoused by courts regarding the duty of disclosure. Part IV provides a general discussion of options and the options market. Finally, Part V ill-
II. The Framework of Rule 10b-5

Congress enacted the Securities Exchange Act of 193430 "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets . . . ."31

One way in which the Exchange Act regulates the securities markets is through its antifraud provisions.32 The general antifraud provision of the Exchange Act is contained in section 10(b).33 Section 10(b) is a broad provision which, among other things, gives the Securities and Exchange Commission (SEC) discretionary rulemaking author-

31. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728 (1975) (quoting unattributed source). The interstate commerce requirement gives the Exchange Act its jurisdictional means. See R. Jennings & H. Marsh, Jr., Securities Regulation, Cases and Materials 1337 (6th ed. 1987). The jurisdictional means has been construed broadly; thus, the use of the mails or any instrumentality of interstate commerce in connection with a securities transaction will invoke the protections of the Exchange Act. For example, the telephone is an instrumentality of interstate commerce. Id. Even an intrastate phone call in connection with a transaction may be sufficient to invoke the Exchange Act. Id.
33. 15 U.S.C. § 78j(b). Section 10(b) proscribes fraud in connection with the purchase or sale of a security:

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.

Id.
The SEC exercised this authority in 1942 to promulgate Rule 10b-5.

Rule 10b-5, like section 10(b), is a flexible antifraud provision. In sweeping language, the rule makes unlawful the use of any fraudulent scheme, device, or practice in connection with the purchase or sale of any security. Although neither section 10(b) nor Rule 10b-5 expressly prohibit insider trading, courts interpret the provisions as encompassing a prohibition against such activity.

See id. Section 4 of the statute creates the Securities and Exchange Commission (SEC). The SEC has authority to regulate the securities markets through various means, including enforcement of the antifraud provisions. See supra note 32.

Rule 10b-5 elaborates on the general provisions of § 10(b):

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


The omission of a material fact and the making of an affirmative misrepresentation in connection with the sale of a security are examples of fraudulent practices under Rule 10b-5. The omission of a material fact and the making of an affirmative misrepresentation in connection with the sale of a security are examples of fraudulent practices under Rule 10b-5. See, e.g., Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1971) (defendants' failure to disclose existence of more profitable market to plaintiffs who sold stock was fraud under Rule 10b-5); Kardon, 69 F. Supp. at 513 (court allowed private cause of action under Rule 10b-5 against defendants who made misrepresentations as part of conspiracy to induce plaintiffs to sell stock).

These antifraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.” In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961); see S. REP. No. 792, supra note 14, at 9 (Exchange Act “aims to protect the interests of the public by preventing directors, officers, and principal [sic] stockholders of a corporation . . . from speculating in the stock [of that corporation] on the basis of information not available to others”); see also H.R. REP. No. 1383, supra note 34.
A. Enforcement of Rule 10b-5's Prohibition Against Insider Trading

Various sanctions, both official and private, may be imposed on insider traders. The federal government may prosecute insider traders for violating Rule 10b-5. The SEC will often assist in the process by turning over findings from its own investigations to the United States Attorney General. Convicted insider traders have received prison sentences.

The SEC also pursues civil sanctions against insider traders under authority granted by section 21 of the Exchange Act. The Commission censures violators by publishing section 21(a) reports of investigations, imposes fines on insider traders and seeks injunctions and disgorgement of unlawful profits. The Insider Trading

14, at 13 ("[m]en charged with the administration of other people's money must not use inside information for their own advantage"); accord T. Levine & H. Pitt, SECURITIES LITIGATION 58 (1983) (one "principal purpose" of Exchange Act was to prevent corporate insiders from profiting at expense of minority shareholders by insider trading) [hereinafter Levine & Pitt]. For further discussion of the application of Rule 10b-5 to insider trading, see infra notes 40-181 and accompanying text.


42. Section 21(d)(1) contains the following provision:
   The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of [the Exchange Act] or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.


43. See, e.g., Stewart & Hertzberg, Levine Receives Prison Term, $362,000 Fine, Wall St. J., Feb. 23, 1987, at 2, col. 1 (convicted insider trader was sentenced to two-year prison term) [hereinafter Levine Receives Prison Term]; Chronology, supra note 8, at 10, col. 2 (four convicted insider traders were sentenced to prison terms between November 6, 1986, and February 9, 1987).


45. A censure is an official reprimand by the SEC. It is the "lightest administrative penalty available to it." Dirks v. SEC, 681 F.2d 824, 829 (D.C. Cir. 1982), rev'd, 463 U.S. 646 (1983).


47. See Levine Receives Prison Term, supra note 43, at 2, col. 1; Chronology, supra note 8, at 10, col. 2.

48. Section 21(d)(1) provides for injunctive relief:
   [Whenever] it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of [the Exchange Act or] the rules or regulations thereunder
Sanctions Act of 1984 (ITSA),\textsuperscript{49} which amended section 21(d) of the Exchange Act, empowers the Commission to seek a civil money penalty for up to three times the amount of profits gained by the insider trader, to be paid into the United States Treasury.\textsuperscript{50} ITSA applies to insider trading in any security, including options.\textsuperscript{51}

The foregoing are examples of enforcement commonly referred to as "official" sanctions. Although these official sanctions are substantial, they have not succeeded in preventing insider trading. Private enforcement of Rule 10b-5 thus provides a necessary supplement to official sanctions.\textsuperscript{52}

Neither section 10(b) nor Rule 10b-5 expressly creates a private civil remedy.\textsuperscript{53} Nevertheless, the Supreme Court has recognized that private actions aid in the enforcement of the securities laws.\textsuperscript{54} A

\begin{itemize}
\item It may in its discretion bring an action in the proper district court to enjoin such acts or practices . . .
\end{itemize}


\textsuperscript{50} The civil penalty provision of ITSA provides as follows:

Whenever it shall appear to the Commission that any person has violated any provision of [the Exchange Act] or the rules or regulations thereunder by purchasing or selling a security while in possession of material non-public information . . . the Commission may bring an 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 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.

\textsuperscript{51} See id. § 78u(d); see also H.R. Rep. No. 355, supra note 1, at 2298.

\textsuperscript{52} See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975).

\textsuperscript{53} The Court made the following observation in Blue Chip:

Section 10(b) of the 1934 Act does not by its terms provide an express civil remedy for its violation. Nor does the history of this provision provide any indication that Congress considered the problem of private suits under it at the time of its passage . . . Similarly there is no indication that the Commission in adopting Rule 10b-5 considered the question of private civil remedies under this provision.

\textsuperscript{54} Id. at 729-30.

\textsuperscript{54} Id. at 730; accord Note, Rule 10b-5: Elements Of A Private Right Of Action, 43 N.Y.U. L. Rev. 541, 563 (1968) (private actions help to deter behavior proscribed by Rule 10b-5) [hereinafter Elements Of A Private Right Of Action].

In the 1946 case Kardon v. National Gypsum Co., a federal district court held for the first time that an implied private right of action exists under Rule 10b-5. 69 F. Supp. 512, 513-14 (E.D. Pa. 1946). The private remedy subsequently flourished in the federal circuits. See, e.g., Hooper v. Mountain States Sec. Corp., 282 F.2d
private remedy also provides compensation for defrauded investors and "serves to bolster public confidence in the securities markets."

B. Elements of the Cause of Action Under Rule 10b-5

As a preliminary matter, in order to bring a private action under Rule 10b-5, a private plaintiff "must allege and prove that he is within the zone of interest Congress intended to protect, . . . and that the injury is directly related to the alleged unlawful conduct." In other words, he must have standing to sue. Generally, a plaintiff is required to have been a purchaser or seller of the securities that form the basis of the fraudulent activity that violates Rule 10b-5. A mere lost opportunity to purchase or sell securities will not satisfy the standing requirement.

Twenty-four years after Kardon, the Supreme Court officially confirmed the private right of action under Rule 10b-5. See Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 13 n.9 (1971) ("[i]t is now established that a private right of action is implied under § 10(b)"). The Court has recently stated that a private Rule 10b-5 action may be brought regardless of the availability of an alternative express remedy under the securities laws. See Herman & MacLean v. Huddleston, 459 U.S. 375, 387 (1983).

The private Rule 10b-5 action has become "the primary private remedy for fraud available under the Securities Exchange Act." HAZEN, supra note 32, at 445. Justice Rehnquist, in Blue Chip, described the remedy in the following manner: "When we deal with private actions under Rule 10b-5 we deal with a judicial oak which has grown from little more than a legislative acorn." Blue Chip, 421 U.S. at 737. See Fridrich v. Bradford, 542 F.2d 307, 314 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

The requirements for standing in a Rule 10b-5 suit were outlined by the Second Circuit in a 1952 decision. See Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). Under the Birnbaum rule, a plaintiff must have purchased or sold securities in connection with the alleged fraud in order to have standing to sue upon that fraud. See id. at 463-64; see also HAZEN, supra note 32, at 450-51.

The Supreme Court adopted the Birnbaum rule in its 1975 decision of Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975). The Court gave several reasons for the purchaser/seller limitation. The Birnbaum rule avoids vexatious litigation, such as nuisance or "strike suits," and saves defendants from making in terrorem settlements. The Court further pointed out that suits brought for lost opportunities

195, 201 (5th Cir. 1960); Fratt v. Robinson, 203 F.2d 627, 632 (9th Cir. 1953); Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 (2d Cir. 1951).

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56. Elements Of A Private Right Of Action, supra note 54, at 563. Bolstering public confidence in the securities markets is the primary motivation behind the securities laws. Cf. supra note 6 and accompanying text (discussing Congressional concern for public's legitimate expectation of fair securities markets).

57. LEVINE & PITT, supra note 39, at 20.

58. Id.

59. The requirements for standing in a Rule 10b-5 suit were outlined by the Second Circuit in a 1952 decision. See Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). Under the Birnbaum rule, a plaintiff must have purchased or sold securities in connection with the alleged fraud in order to have standing to sue upon that fraud. See id. at 463-64; see also HAZEN, supra note 32, at 450-51.

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An option does not merely afford its holder the opportunity to purchase or sell securities; the option contract is itself a security. In Blue Chip Stamps v. Manor Drug Stores, the Supreme Court stated that "the holders of puts, calls, options, and other contractual rights or duties to purchase or sell securities have been recognized as 'purchasers' or 'sellers' of securities for purposes of [R]ule 10b-5 ..." In 1982, the Exchange Act was amended "to expressly include options on securities within the definition of 'security' ..." Defrauded option traders therefore have standing to sue under section 10(b) and Rule 10b-5. Once a plaintiff has established standing to sue, he must then prove the elements of the cause of action—generally scienter, materiality, reliance, causation and damages.

1. Scienter

Scienter is a necessary element of the 10b-5 cause of action. The Supreme Court, in Ernst & Ernst v. Hochfelder, provided that a Rule 10b-5 plaintiff must allege and prove an "intentional wrong-

are often based on oral evidence, making the proof of facts unduly difficult. See id. at 739-44.
60. See Blue Chip, 421 U.S. at 731-33. The irony of the Birnbaum rule is that those who lose an opportunity to realize a profit or avoid a loss may be the real victims of an insider trade. See generally Wang, supra note 6, at 1217.
64. See, e.g., Backman, 540 F. Supp. at 671; O'Connor, 529 F. Supp. at 1186.
65. See generally HAZEN, supra note 32, at 445-75. The elements mentioned in the text are generally required for the private cause of action. In enforcement actions, however, the prosecution need only prove scienter and materiality. See SEC v. Materia, 745 F.2d 197, 201-03 (2d Cir. 1984), cert. denied, 471 U.S. 1053 (1985).
66. See generally Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197-214 (1976). The Court has also held that scienter is a necessary element in SEC enforcement actions brought under Rule 10b-5. See Aaron v. SEC, 446 U.S. 680, 691 (1980).
doing' by the defendant, that is, something beyond mere negligence.\textsuperscript{68} The Court elaborated on the scienter element in \textit{Santa Fe Industries, Inc. v. Green}\textsuperscript{69} by requiring a showing of intent to manipulate or deceive.\textsuperscript{70} Notwithstanding the Court's emphasis on intent, the majority of circuit courts has held that recklessness is sufficient proof of scienter under Rule 10b-5.\textsuperscript{71}

2. \textit{Materiality}

Information omitted or misstated by a defendant must be material in order to sustain a Rule 10b-5 claim.\textsuperscript{72} Information is material if "there is a substantial likelihood that a reasonable [investor] would consider it important" in deciding his choice of action in the transaction in question.\textsuperscript{73} Furthermore, a reasonable investor would attach importance to information if, upon disclosure, the information would "significantly alter[] the 'total mix' of information made available."\textsuperscript{74}

3. \textit{Reliance}

In general, in order to allege fraud in a Rule 10b-5 action, a plaintiff must have acted in reliance upon a material misstatement or omission by the defendant.\textsuperscript{75} The plaintiff must prove that the defendant's misconduct was a significant, contributing cause of his

\textsuperscript{68} Id. at 214. The Court noted that certain circuit courts had held that recklessness satisfied the scienter requirement of Rule 10b-5. \textit{Id.} at 193-94 n.12. The Court declined, however, to address whether recklessness was indeed sufficient proof of scienter. \textit{Id.}

\textsuperscript{69} 430 U.S. 462 (1977).

\textsuperscript{70} The Court made the following holding: "The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception .... Thus [a] claim of fraud ... states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute." \textit{Id.} at 473-74.


\textsuperscript{72} See \textit{Hazen}, supra note 32, at 461-63.


\textsuperscript{74} \textit{Id.}

injurious trade. Nevertheless, in nondisclosure cases such as insider trading claims, positive proof of reliance is not a prerequisite to recovery. In *Affiliated Ute Citizens v. United States*, the Supreme Court held that in such cases the obligation to disclose, combined with an actual withholding of a material fact, is sufficient to establish the requisite element of causation in fact, or reliance. Although lower courts interpret *Affiliated Ute* differently, the general trend is to minimize the reliance element in nondisclosure cases.

4. Causation

The concepts of reliance and causation are very closely related. The causation element may be divided into two parts—"transaction causation" and "loss causation." In order to prove transaction causation, which is substantially similar to reliance, a plaintiff must

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77. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153 (1972). Even in cases involving affirmative misrepresentations, courts have eased a plaintiff's burden of proving reliance by adoption of the "fraud-on-the-market" theory. See, e.g., *Basic*, 56 U.S.L.W. at 4236-39 (plaintiffs' reliance on integrity of price set by market, which had been manipulated by defendants' material misrepresentations, created rebuttable presumption of reliance). For further discussion of the fraud-on-the-market theory, see *Hazen*, supra note 32, at 465-66.


79. Id. at 154; see also *Basic*, 56 U.S.L.W. at 4237 (restating *Affiliated Ute*’s presumption of reliance upon showing of nondisclosure and materiality).

80. Compare Rifkin v. Crow, 574 F.2d 256, 262 (5th Cir. 1978) (*Affiliated Ute* creates rebuttable presumption of reliance upon showing of nondisclosure and materiality) with *Fridrich*, 542 F.2d at 319 (*Affiliated Ute* applies only to face-to-face situations and otherwise requires positive proof of reliance) and *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 240 (2d Cir. 1974) (*Affiliated Ute* dispenses with reliance requirement upon showing of nondisclosure and materiality).

81. See *Hazen*, supra note 32, at 463-64.

82. See *Levine & Pitt*, supra note 39, at 50 ("[c]ourts often use the words interchangeably to convey the same idea").


84. In a Rule 10b-5 context, reliance and transaction causation are parallel concepts. If a plaintiff trades securities in reliance on a defendant's misstatement or omission, it follows that the defendant's misconduct is a substantial cause in fact of the trade. See Note, *Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658, 672 (1965) ("proof of reliance may always establish that defendant caused the plaintiff's conduct"). It is important to note, however, that there may be instances when a
prove that the defendant’s misconduct caused the plaintiff’s trade of securities. To prove loss causation, however, a plaintiff must further prove that the defendant’s misconduct caused his losses sustained on the market.

5. Damages

Finally, a Rule 10b-5 plaintiff may recover damages. The customary measure of damages in a Rule 10b-5 claim is the plaintiff’s out-of-pocket loss. In some insider trading cases, however, plaintiffs have been allowed a restitutionary recovery. The insider’s profits are viewed as unjust enrichment, and must be disgorged to the defrauded plaintiff.

III. Differing Views Regarding the Prohibition Against Insider Trading Under Rule 10b-5

The insider trader’s offense is his silence concerning material nonpublic information about his company’s securities in connection with his trade. A person’s silence regarding nonpublic information may be considered fraudulent, however, only if he is under a duty to disclose the information to others. Moreover, the duty to disclose...
arises only out of a special kind of relationship—a fiduciary relationship.91

A. Special Relationships Giving Rise to a Duty to Disclose

The Supreme Court has long recognized that a duty of disclosure arises from a person’s status as a fiduciary.94 In 1909, in Strong v. Repide,95 the Court held that a director of a corporation who knew “special facts” affecting the value of shares and who concealed those facts when he purchased shares, violated his duty as a fiduciary by failing to disclose those facts to a selling shareholder.96 Directors, officers and majority shareholders commonly have access to confidential corporate information,97 and hence are “traditional corporate ‘insiders.’ ”98 It is well settled that these persons owe a fiduciary duty to the corporation and its shareholders.99

Courts have also created categories of non-traditional insiders, quasi-insiders, and misappropriators upon whom they impose a fiduciary duty and thus the duty to disclose. Tippees, persons who receive material nonpublic information from insiders,100 are but one example. In Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,101 the Second Circuit held that tippees of a breaching insider were subject to the same duty to disclose or abstain102 as the insider.103


95. 213 U.S. 419 (1909).

96. See id. at 430-34. The “special facts” concept has evolved into the concept of material nonpublic information.

97. See id.; see also HAZEN, supra note 32, at 419.


100. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974).

101. 495 F.2d 228 (2d Cir. 1974).

102. For a discussion of the “disclose or abstain” rule, see infra notes 113-25 and accompanying text.

103. See Shapiro, 495 F.2d at 237-38.
Factual circumstances may exist where a defendant who is not an insider is deemed to have a relationship of trust and confidence with the parties to a transaction. In SEC v. Capital Gains Research Bureau, the Supreme Court recognized a fiduciary relationship between an investment adviser and his clients to whom he had made personal recommendations. In Affiliated Ute, the Court again recognized such a relationship in a face-to-face transaction. In each case the fiduciary was required to disclose material facts to the trading plaintiffs.

Finally, the misappropriation theory, developed in the Second Circuit in United States v. Newman, has been employed in criminal and SEC enforcement actions in order to impose liability upon outsiders for trading on confidential information. The theory holds that when an employee misappropriates confidential information from his employer and then trades on that information, the employee breaches a fiduciary duty owed to the employer. Moreover, the activity is fraud within the meaning of Rule 10b-5. The violation, however, comes from the misappropriation and subsequent trade rather than from a failure to disclose.

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105. Id. at 193.
107. See id. at 152 (bank employees in whom plaintiffs placed their trust and confidence were held liable for purchasing shares of plaintiffs' trust fund without disclosing more beneficial secondary market). Most securities transactions are of a more impersonal nature. Sales which occur in an impersonal market such as an exchange or the over-the-counter market will not of themselves create a relationship of trust and confidence between parties. See infra note 222 and accompanying text.
108. See Affiliated Ute, 406 U.S. at 153; Capital Gains, 375 U.S. at 201.
111. See Materia, 745 F.2d at 202-03 (court stresses that in enforcement action it need not find duty to particular plaintiff).
112. See id. Materia suggests that the misappropriation theory would not be an effective means of recovery for a private 10b-5 plaintiff other than the misappropriator's employer. See id. (court implied that private cause of action based on misappropriation would fail because plaintiff could not show that defendant owed him duty of disclosure). But see Chiarella, 445 U.S. at 240 (Burger, C.J., dissenting).
B. The Duty to Disclose or Abstain From Trading

Since *Strong v. Repide*, it has been well established that in face-to-face transactions between a corporate insider and shareholders, the insider's fiduciary relationship to the shareholders compels disclosure of material nonpublic information. It was not until an SEC decision, *In re Cady, Roberts & Co.*, in 1961, however, that insider trading in the impersonal markets was held to violate Rule 10b-5. The Commission concluded:

Analytically, the obligation [to disclose] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

The Commission relied on an insider's fiduciary duty of loyalty to shareholders in imposing an affirmative duty to disclose material information in order to enable a shareholder to properly evaluate the consequences of his trade. The duty of disclosure, however, is not an absolute one. If the insider abstains from trading on the confidential information, he will not be subject to liability under Rule 10b-5. The "disclose or abstain" rule of *Cady, Roberts* was first adopted by the federal courts in 1968, in *SEC v. Texas Gulf &

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In *Chiarella*, the majority did not reach the misappropriation issue because it found that it was not properly introduced to the jury. *Id.* at 236. In his dissenting opinion, Chief Justice Burger wrote: "I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 240 (Burger, C.J., dissenting). This interpretation would allow a private plaintiff to argue that he is owed a duty of disclosure.

113. 213 U.S. 419 (1909).
114. *See Langevoort*, *supra* note 6, at 5.

116. *See Langevoort*, *supra* note 6, at 8. In *Cady, Roberts*, a director of Curtiss-Wright tipped a broker-dealer that the company's board of directors had voted to reduce the dividend for the next fiscal quarter. The broker-dealer immediately placed sell orders on the New York Stock Exchange for some of his customers who held Curtiss-Wright stock. The transactions were completed before the public was informed of the reduced dividend. *See Cady, Roberts*, 40 S.E.C. at 909. Although the broker-dealer was not a traditional insider, the Commission imposed upon him "the responsibilities of those commonly referred to as 'insiders' " due to his relationship with the tipping director. *Id.* at 912.

117. 40 S.E.C. at 912 (footnote omitted).
118. *See Langevoort*, *supra* note 6, at 8.
Sulphur Co.\textsuperscript{120} In \textit{Texas Gulf Sulphur},\textsuperscript{121} the Second Circuit expanded the rule beyond insiders to reach anyone in possession of inside information.\textsuperscript{122} This concept has been termed the "parity-of-information" rule.\textsuperscript{123}

The Supreme Court, in \textit{Chiarella}, however, rejected the parity-of-information rule. The Court held that "a duty to disclose under [section] 10(b) [and Rule 10b-5] does not arise from the mere possession of nonpublic market information."\textsuperscript{124} The Court made clear that "a duty to disclose aris[es] from a relationship of trust and confidence between parties to a transaction."\textsuperscript{125}

C. To Whom is the Duty of Disclosure Owed?

It is now widely accepted that the duty to disclose or abstain arises from a fiduciary relationship.\textsuperscript{126} There are two views, however,

\begin{itemize}
\item 120. 401 F.2d 833, 848 (2d Cir. 1968), \textit{cert. denied sub nom.} Kline v. SEC, 394 U.S. 976 (1969). The rule was also extended to private actions under Rule 10b-5, see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974), and was ultimately confirmed by the Supreme Court. \textit{See} Chiarella v. United States, 445 U.S. 222, 226-27 (1980).
\item 121. Officers of Texas Gulf Sulphur Co. learned through an exploratory drilling procedure that one of the company's properties had tested extremely well for an ore discovery. \textit{See} Texas Gulf Sulphur, 401 F.2d at 843-44. The officers purchased stock without disclosing material nonpublic information concerning the drilling results. \textit{Id.} at 841-42.
\item 122. The court interpreted \textit{Cady, Roberts} very broadly. Because \textit{Cady, Roberts} had imposed liability on tippees who were not insiders, the Second Circuit concluded that "\textit{anyone in possession} of material inside information must either disclose it to the investing public . . . or [if] he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." \textit{Id.} at 848 (emphasis added).
\item 123. \textit{See} Chiarella, 445 U.S. at 231-33. The rule is based on what the Second Circuit viewed as the policy behind Rule 10b-5, "the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." \textit{Texas Gulf Sulphur,} 401 F.2d at 848. One commentator termed it "a fairness-oriented disclosure rule." \textit{Corporate Recovery, supra} note 9, at 489. The Second Circuit followed the parity-of-information rule for over ten years, until it was implicitly overruled by \textit{Chiarella}. \textit{See, e.g.,} Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94 (2d Cir. 1981) (court reaffirms \textit{Texas Gulf Sulphur} rule); U.S. v. Chiarella, 588 F.2d 1358, 1364 (2d Cir. 1978) (\textit{Texas Gulf Sulphur} rule is "black letter law"), \textit{rev'd}, 445 U.S. 222, 237 (1980).
\item 124. \textit{Chiarella,} 445 U.S. at 235; \textit{see also} Dirks v. SEC, 463 U.S. 646, 653-59 (1983).
\item 126. One court that has followed the fiduciary principle has stated, "[t]he doctrine
INSIDER TRADING

concerning the persons to whom the duty of disclosure is owed.

1. Shapiro—Duty Owed to the General Investing Public

In Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Merrill Lynch was the managing underwriter of an offering of Douglas Aircraft debentures. In confidence, Douglas advised Merrill Lynch and certain of its officers, directors and employees of material adverse information regarding the company's recent earnings. Merrill Lynch "tipped" the information to certain of its customers, who knew or should have known that they were receiving inside information. The tippees then sold Douglas stock on the New York Stock Exchange before the information was disclosed to the public. Upon disclosure of the adverse information, the price of Douglas stock dropped sharply.

The plaintiffs, investors who traded Douglas stock during the period of insider trading, brought suit against Merrill Lynch and its tippees alleging that the defendants owed a duty of disclosure to the "general investing public." The case came before the Second Circuit on the defendants' appeal from the district court's refusal to render judgment on the pleadings. The court held that Merrill Lynch and its tippees "were under a duty to the investing public, including plaintiffs, not to trade in or to recommend trading in Douglas stock without publicly disclosing

that a duty to disclose or refrain from trading arises from a specific relationship between two parties—and not simply from the fact that some investors have more information than others—is now established in both state and federal law." Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 n.6 (2d Cir. 1980).

It should also be noted that while other courts agree that the duty of disclosure arises from a fiduciary relationship, they have not required a fiduciary relationship between the parties to the transaction. See, e.g., Bianco v. Texas Instruments, Inc., 627 F. Supp. 154, 163-64 (N.D. Ill. 1985) (recognizing duty of disclosure to investing public arising from insider's fiduciary duty to his corporation); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1185 (S.D.N.Y. 1981) (same).

127. 495 F.2d 228 (2d Cir. 1974).
128. Id. at 231.
129. Id. at 232.
130. Id.
131. Id.
132. Id. at 233.
133. Id.
134. Id.
135. Id. at 234.
the revised earnings information which was in their possession."136 This broad duty of disclosure was in accordance with the court's view of Rule 10b-5's purpose, "to protect the investing public and to secure fair dealing in the securities markets by promoting full disclosure of inside information so that an informed judgment can be made by all investors who trade in such markets."137

The defendants argued that since the plaintiffs lacked transactional privity and could not prove reliance, the plaintiffs had failed to prove causation.138 The court rejected the privity argument139 and found reliance based on the defendants' duty to disclose coupled with the withholding of material facts.140

Although Shapiro found a duty owed to the entire investing public, the court limited the scope of the defendants' liability through the

136. *Id.* at 240 (emphasis added). The opinion employed the Texas Gulf Sulphur parity-of-information rule. *Id.* See supra notes 120-25 and accompanying text for a discussion of the parity-of-information rule. The facts clearly indicate, however, that Merrill Lynch stood in a fiduciary relationship with Douglas and its shareholders. *See Shapiro,* 495 F.2d at 231-32.

137. *Shapiro,* 495 F.2d at 235.

138. *Id.* at 238. For a review of the reliance and causation elements, see supra notes 75-86 and accompanying text. In this instance, the court used the terms reliance and causation interchangeably.

139. "[T]he common law requirement of privity has all but vanished from 10b-5 proceedings while the distinguishable 'connection' element is retained." *Shapiro,* 495 F.2d at 239 (quoting *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 101 (10th Cir.), cert. denied, 404 U.S. 1004 (1971)). The court likely recognized that matching buyers and sellers is extremely difficult in the impersonal market. Therefore, refusing to create a buffer from liability, the court rejected a privity requirement. *Id.* But see *Fridrich v. Bradford,* 542 F.2d 307, 321 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977). The Sixth Circuit refused to extend the private 10b-5 remedy to impersonal market situations in which a plaintiff neither dealt with nor relied on the defendant. *Id.* *Fridrich* has been read as requiring strict privity between plaintiff and defendant. *See Comment, Private Rule 10b-5 Recovery for Open Market Insider Trading: The Propriety of Privity and Reliance Requirements,* 15 San Diego L. Rev. 751, 757-58 (1978).

140. See *Shapiro,* 495 F.2d at 238. The court cited *Affiliated Ute,* which minimized the reliance element in nondisclosure cases. See supra notes 77-81 and accompanying text. *But see Fridrich,* 542 F.2d at 321. *Fridrich* denied recovery to plaintiffs who could prove neither privity nor reliance. *Id.* The *Fridrich* court distinguished *Affiliated Ute* as being applicable only in face-to-face transactions. See *id.* at 318-20 (court required positive proof of reliance in absence of prior dealings between parties). *Fridrich* severely limits the liability of an insider who trades on an exchange. The court believed that enforcement of the antifraud provisions was a task for the SEC, and that only those plaintiffs who could prove actual injury should recover damages. See *id.* at 320-21. Only the Sixth Circuit has followed *Fridrich.* See Imperial Supply Co. v. Northern Ohio Bank, 430 F. Supp. 339, 356 (N.D. Ohio 1976).
causation requirement. That is, only those claimants who traded during the same period as the insiders were permitted to recover damages from the defendants.

Since Chiarella, however, the Second Circuit, in Moss v. Morgan Stanley Inc., has retreated from the Shapiro rule. Nevertheless, some courts have continued to embrace the view that the duty of disclosure is owed to the entire investing public.

2. Chiarella, Dirks, Moss—Duty Owed to Those Who Stand in a Fiduciary Relationship With the Insider Trader

Several cases have rejected Shapiro and have adopted a more limited view as to the scope of the duty of disclosure. In Chiarella v. United States, the defendant, Chiarella, was an employee of a financial printer. Among the documents he handled were five announcements of takeover bids with the names of acquiring and target companies concealed or falsified to protect against their use. Chiarella nevertheless was able to deduce the names from other information contained in the documents. Without disclosing this information, he purchased shares of the target companies and immediately sold them at a profit after the takeover attempts were

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141. Causation here refers to "loss causation." See supra notes 83-86 and accompanying text.
142. Shapiro, 495 F.2d at 241. This outcome suggests that only the losses of those who trade contemporaneously with the insider are caused by the insider's conduct. See Wilson v. Comtech Telecommunications Corp., 648 F.2d 88, 94-95 (2d Cir. 1981) ("non-contemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information").
144. See infra notes 172-81 and accompanying text.
145. See, e.g., O'Connor & Assoc. v. Dean Witter Reynolds, Inc., 600 F. Supp. 702, 703 (S.D.N.Y. 1985) ("by virtue of their fiduciary duty to the corporation and its shareholders, corporate insiders become subject to the separate duty to either 'abstain or disclose'. . . . (This additional duty to disclose is owed to the investing public, . . . to those investors trading contemporaneously with the insider") (quoting Shapiro, 495 F.2d at 240, and Wilson, 648 F.2d at 94, respectively); Bianco v. Texas Instruments, Inc., 627 F. Supp. 154, 163-64 (N.D. Ill. 1985) ("[b]ecause the securities laws are designed to protect the entire open market . . . [the] duty [to disclose] is owed not only to the shareholders of the corporate employer, but also to the investing public at large").
147. Id. at 224.
148. Id.
149. Id.
made public. Following an SEC investigation of his trading activities, Chiarella was indicted and convicted of violating section 10(b) and Rule 10b-5. The Second Circuit affirmed the conviction based on the parity-of-information rule.

The Supreme Court reversed and rejected the Shapiro rule that the duty of disclosure is owed to the investing public. The Court explained that the duty to disclose is imposed upon a party not merely because he possesses material nonpublic information, but because another party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.

The Court held that Chiarella did not owe a duty of disclosure because he did not stand in a fiduciary relationship to the shareholders of the target companies. It appears, therefore, that under the fiduciary principle, the duty to disclose runs only to those who stand in a fiduciary relationship with the party that trades on material nonpublic information.

The fiduciary principle was reaffirmed by the Court three years later in \textit{Dirks v. SEC}. In \textit{Dirks}, a former officer of Equity Funding of America (Equity Funding) tipped material adverse information about the company to the defendant Dirks, a broker-dealer, and urged Dirks to disclose that information publicly. Dirks investigated

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\begin{itemize}
\item 150. \textit{Id.}
\item 151. \textit{Id.}
\item 152. \textit{Id.} at 225.
\item 154. \textit{Chiarella,} 445 U.S. at 237.
\item 155. "We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information." \textit{Id.} at 235.
\item 156. \textit{Id.} at 228 (quoting \textit{RESTATEMENT (SECOND) OF TORTS} § 551(2)(a) (1976)). The Court based its ruling on the common law fraud doctrine. \textit{See id.} at 227-29.
\item 157. \textit{See id.} at 232.
\item 158. The Court explained its holding in the following manner:
\begin{quote}
We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo 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.
\end{quote}
As we have seen, no such evidence emerges from the language or legislative history of § 10(b).
\textit{Id.} at 233 (citations omitted).
\item 159. 463 U.S. 646 (1983).
\item 160. \textit{Id.} at 649.
\end{itemize}
\end{flushleft}
Equity Funding and found its corporate assets to be vastly overstated. Dirks did not trade in Equity Funding securities; he did, however, discuss the fraud with clients who then began to liquidate their holdings in the company. The SEC investigated Dirks for his participation and censured him for not disclosing the fraud. Dirks sought review of the censure, which was upheld by the Court of Appeals for the District of Columbia.

The Supreme Court reversed and took the opportunity to redefine tippee liability and to reiterate the fiduciary principle established by Chiarella. The Court reemphasized that the duty to disclose arises from a specific relationship between the parties.

Chiarella and Dirks involved, respectively, a criminal action and an SEC enforcement action brought under Rule 10b-5. Neither case addressed private recovery under the Rule, yet many courts have incorporated the fiduciary principle into the cause of action. Moss v. Morgan Stanley Inc. illustrates the adoption of the fiduciary principle in the Second Circuit. In Moss, the defendant, Morgan Stanley, was employed by Warner Lambert Co. to assess

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161. Id.
162. Id.
163. Id. at 650-52.
164. Id. at 651-52.
166. 463 U.S. at 667.
167. "[A] tippee's duty to disclose or abstain is derivative from that of the insider's duty." Id. at 659. A tippee such as Dirks does not "assume an insider's duty to the shareholders ... [unless the information] has been made available to him improperly." Id. at 660 (emphasis in original). The Court held that because the officer did not personally benefit from his tip, he did not breach a duty to Equity Funding shareholders, and, therefore, nor did Dirks as his tippee. Id. at 662. The Court gave the following explanation:

[A] purpose of the securities laws was to eliminate "use of inside information for personal advantage." ... Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.

Id. (quoting In re Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)).
168. See id. at 654-55.
169. Id. at 657-58.
170. See id. at 650-52; Chiarella, 445 U.S. at 225.
the desirability of Deseret Pharmaceutical Co. (Deseret), a potential takeover target. One Courtois, an employee of Morgan Stanley, tipped information to certain other defendants of an imminent tender offer for Deseret stock, and the tippees purchased Deseret shares without disclosing that information. The following day, Warner Lambert announced a tender offer for Deseret stock and the defendant-tippees tendered their shares, thereby reaping a substantial profit. The plaintiffs were Deseret shareholders who sold their shares on the same day the defendants purchased Deseret shares. The plaintiffs alleged that the defendants owed them a duty of disclosure.

The District Court for the Southern District of New York dismissed the complaint, concluding that because there was no fiduciary relationship between the parties, the defendants were under no duty to disclose the inside information. The Second Circuit, relying on Chiarella and Dirks, affirmed the decision. The panel agreed that the insiders of the acquiring company and their tippees shared no fiduciary relationship with the shareholders of the target company and that they therefore owed no duty of disclosure. Moss is one of many cases which has held that the fiduciary principle is applicable in private causes of action under Rule 10b-5.

IV. The Stock Option

A stock option is a "contract which allows the buyer, by exercise, to buy or sell stock (usually in 100-share units) at a certain price (exercise or striking price) over a certain period of time, regardless of how high or low the price of the stock (the underlying security) moves during that time." Options are reciprocal in nature. They

173. Id. at 8.
174. Id.
175. Id.
176. Id.
177. Id. at 8-9.
179. Moss, 719 F.2d at 12-15.
180. Id. at 12-15.
182. SPECIAL STUDY, supra note 9, at xxi.
create both a right in one party and an obligation in another.\textsuperscript{183} These rights and obligations end on the expiration date of the option.\textsuperscript{184} The option buyer pays a premium\textsuperscript{185} to the option writer\textsuperscript{186} in exchange for the contract.

An option giving its holder the right to buy underlying stock is a "call option."\textsuperscript{187} One which gives its holder the right to sell the underlying stock is a "put option."\textsuperscript{188} Puts and calls are the two basic types of options; however, there are also more complex options positions.\textsuperscript{189}

Until 1973, options were sold only in the over-the-counter market (OTC).\textsuperscript{190} Options were negotiated individually between buyers and sellers through broker-dealers, and accordingly were not standardized.\textsuperscript{191} The individualized nature of options made trading costly and difficult. As a result, OTC options were rarely traded.\textsuperscript{192} Trading of listed options—those traded on a national securities exchange\textsuperscript{193}—

\begin{itemize}
\item \textsuperscript{183} See id. at 76. For example, the holder of a call option has the right to buy shares. The writer has the obligation to sell those shares to the holder if the holder exercises his right to buy them. Id.
\item \textsuperscript{184} Id. at 78. Listed options have a maximum duration of nine months, but they are usually written for shorter periods. As of 1979, over 60\% of the existing options volume had a duration of less than four months. See id. at 84.
\item \textsuperscript{185} See id. at 76. The premium is an absolute cost to the buyer. If he exercises the option he will incur further transaction costs, e.g., commissions.
\item \textsuperscript{186} The writer of the option is the seller of the option. Id. at xxv.
\item \textsuperscript{187} This type of option allows the buyer to "call" upon the seller for shares. Id. at 76.
\item \textsuperscript{188} The contract allows the seller to "put" shares to the buyer. Id.
\item \textsuperscript{189} The two may be employed in complex trading strategies. For example, a spread is an options position created by the buying and selling of options of the same class (a class being options of the same type, e.g., calls, that cover the same underlying security), but which are of different series (a series being options of the same class that have the same exercise price and expiration date). Id. at xvii, xxiv. Another example is a straddle. A straddle is a combination option position consisting of a put and a call of the same class and usually of the same series, with both options exercisable separately. See id. at xxv. For further discussion of the use of straddles, see id. at 123-24.
\item \textsuperscript{190} The OTC market is a network on which any registered broker-dealer may act as a dealer. The National Association of Security Dealers' automated quotation computer system (NASDAQ) lists quotations of market makers. Transactions may be consummated by telephone communication with the market maker. See generally Senate Comm. on Banking, Housing and Urban Affairs, 93d Cong., 1st Sess., Report of the Subcomm. on Securities 89-94 (Comm. Print 1973). See infra note 241 for a discussion of market makers.
\item \textsuperscript{191} See Special Study, supra note 9, at 73.
\item \textsuperscript{192} See id.
\item \textsuperscript{193} Id. at xx.
\end{itemize}
began in 1973. Unlike OTC options, listed options are standardized and are easily traded.

A secondary market in listed options is made possible both by the standardized terms of the contracts, and because they are issued and guaranteed by only one entity, the Options Clearing Corporation (OCC). The OCC stands as an intermediary between buyers and sellers. For example, when a call option is exercised, the writer, or seller, of the option delivers the stock to the OCC. The OCC then delivers the stock to the buyer. The buyer pays the exercise price to the OCC and the OCC delivers payment to the seller. The parties to the transaction deal only with the OCC and not with one another.

Options are most often used by investors as a substitute for short-term purchases and sales of stock. By using options, an investor spends less on transaction costs because commissions are lower for options transactions. This in turn enables (using calls as an example) the option trader to obtain a much larger position in a stock, with a limited amount of capital expenditure, than he would if he were simply buying shares.

The buying of call options, however, "entails a substantially higher degree of risk than does the simple investment in the underlying stock because relatively large increases in the price of the underlying

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194. See id. at 1.
195. A special study of the options market for the SEC drew the following conclusions:
   Listed options differ from conventional options in several important ways including: 1) a liquid secondary market exists for the trading of listed options; 2) transaction costs associated with listed options are lower than those for conventional OTC options; and 3) up-to-date quotations and transaction prices on listed options are obtainable, during the trading day, through quotation and price reporting services found in brokerage firms; and closing prices are available through newspapers.

196. See id. at 73.
197. See id.
198. See id.
199. See id.; see also H.R. REP. NO. 355, supra note 1, at 2782.
200. Transaction costs are the expenses incurred from the purchase or sale of securities, of which commissions represent the largest part. See SPECIAL STUDY, supra note 9, at xxv.
201. "[T]he dollar amount of commissions on an option will be less than on a stock trade in an equivalent number of shares underlying the option." Id. at 89.
202. See id. at 109; see also Laventhall v. General Dynamics Corp., 704 F.2d 407, 410 (8th Cir.), cert. denied, 464 U.S. 846 (1983) ("options are bought because they offer an investor a potential profit from a limited dollar exposure").
stock are required if the buyer is to profit from this activity." Although the cost of the option is a relatively small investment for the trader, he nevertheless stands to lose his investment completely if he holds the option for its duration. Of course, the risk is balanced against the lower cost and potentially high profitability of investing in options.

An option holder may elect to sell the option at any time. Its price reflects the market value of the rights transferred. An option's price will be affected by the same factors which influence the price of the underlying stock.

V. Insider Trading in Options: The Loophole

The SEC recognized the potential for abuse in options trading when it warned in 1979 that "[t]he leverage offered by options, which permits substantial percentage gains on a small capital investment, and the existence of a liquid market for options have created new opportunities for profitable options trading based on nonpublic market information." In the legislative history of the Insider Trading Sanctions Act of 1984 (ITSA), Congress noted that "the purchase of options permits the violator to obtain far larger illegal profits than would be possible through purchases of the same dollar amount of common stock." Option trading is generally highly speculative. An investor accepts the risk that the price of a stock might not reach the level necessary for exercise of the option to become profitable because his rewards will be great if the price does change accordingly. The insider, however, can trade

203. SPECIAL STUDY, supra note 9, at 108.
204. See id. at 109; see also Laventhal, 704 F.2d at 410. The holder of a call option will not exercise his option unless the price of the underlying stock rises to a profitable level above the exercise price.
205. See SPECIAL STUDY, supra note 9, at 73 (liquid secondary market exists for trading listed options).
206. See id. at 90. For a more detailed discussion of options pricing, see id. at 90-95.
207. For example, the announcement of a takeover bid will substantially increase the price of a call option on the target company's stock. See H.R. REP. No. 355, supra note 1, at 2296 n.38.
208. SPECIAL STUDY, supra note 9, at 183; see also Corporate Recovery, supra note 9, at 506-07 ("[t]rading in [options] is particularly subject to abuse of inside information because it provides opportunity for large gains relative to the amount of investment at risk").
options with essentially no risk involved. He is like the gambler who bets on an event after its occurrence, but before the public knows it has occurred. For example, in a takeover situation, tender offerors offer substantial premiums over the prevailing market price of the target company's securities. The insider of a target company, well aware of this, knows that an impending tender offer for the stock is sure to exceed the exercise price of call options on his company's stock written in accordance with the pre-offer market price. Moreover, the price of the options themselves will increase dramatically. The insider may trade options on his company's stock based on this material nonpublic information in the same way he might trade the stock itself. The irony is that while he would violate Rule 10b-5 for trading stock without disclosing the information, he would not violate the Rule by trading options. Hence, the fiduciary principle creates an options loophole.

A. The Trade

The following hypothetical illustrates the loophole as it exists in the secondary market: On December 1, 1987, Plaintiff (P) buys 100 call options written on X Co. stock from the OCC. The options are written by W, who sold the options to the OCC. The options are exercisable at fifty-five dollars per share, and on the purchase date and throughout the month of December, X Co. stock sells for fifty dollars per share. On January 1, 1988, Y Co.'s takeover proposal comes before the board of directors of X Co. Y Co. offers sixty-five dollars per equity share. On January 2, 1988, before the board reaches a decision, Director (D), a director of X Co., places an order with his broker to buy 100 call options on X Co. stock, for 100 shares each, with an exercise price of fifty-five dollars per share. The broker buys 100 call options from P via the Chicago Board Options Exchange (CBOE). On January 3, 1988, along with the announcement of the takeover bid, the X Co. board announces its

211. Id. at 2295.
212. See id.
213. See id. at 2295-96.
214. See infra notes 216-23 and accompanying text. This discussion will focus only on § 10(b) and Rule 10b-5. It does not suggest that the insider is necessarily free from liability under other provisions of the securities laws.
215. See Langevoort, supra note 6, at 42 (strict application of fiduciary principle "would open a large loophole for insiders to profit from confidential information"); Corporate Recovery, supra note 9, at 507 ("it is virtually impossible to prevent informational abuses involving [options] through application of the fiduciary principle").
decision to accept the offer. If D exercises the call options, the OCC will deliver to him 10,000 shares of X Co. stock. The OCC will in turn call on W to deliver 10,000 shares of X Co. stock. D may immediately resell the stock to Y Co., thereby realizing a profit of nearly $100,000 after transaction costs are deducted. He may also decide to merely sell the call options, the value of which would increase proportionately with the increase in the price of X Co. stock following the announcement of the tender offer. This strategy would still allow D a substantial profit with only a minimal capital expenditure.216

D, as a director of X Co., is clearly a traditional insider.217 His acts are contemptible, yet, arguably, not illegal under the fiduciary principle. Moreover, D will not be liable to P, the option trader,218 for his trade on material nonpublic information.

B. The Loophole Under the Fiduciary Principle

P may bring suit against D, alleging that had P known of the inside information, he would not have traded the options. In order to prevail under section 10(b) and Rule 10b-5, P must prove that D committed a fraud by his nondisclosure.219 D, however, was under no duty to disclose to P because he did not stand in a fiduciary relationship with P.220

While it is true that shareholders and options traders both rely on the fortunes of corporations, the dispositive distinction is that the options trader has no equity interest in the corporation by virtue of his selling or purchasing an option on the corporation's stock. He is owed no special duty by the officers and directors of the corporation because, quite simply, the corporation is not run for his benefit. He has contributed no equity to the corporation

216. See supra notes 205-07 and accompanying text.
217. See supra notes 97-99 and accompanying text.
218. The option trader is the previous holder of the options, for whose account they were sold. In this hypothetical, the option writer has no cause of action, for he could not prove the requisite causation element. The information regarding the takeover bid did not exist at the time the options were written on December 1, 1987. He was, therefore, in no way effected by D's nondisclosure on January 1, 1988. The possibility that the market price of the underlying stock may be inflated by the announcement of a tender offer is an inherent risk of writing call options.
219. See supra notes 91-93 and accompanying text.
Whatever relationship this may create with the corporation, it cannot be said that it rises to the level of a relationship of trust and confidence between the options trader and the corporate insider. In short, as a shareholder one is entitled to the benefits of a trust relationship. As an options trader, one is not.

Chiarella makes clear that the duty to disclose arises from a fiduciary relationship between parties to a transaction. Since there is no fiduciary relationship between an insider and an option trader, an insider could theoretically trade solely in options and not violate Rule 10b-5.

C. Alternative Resolutions

Insiders should not be allowed to exploit investors. Courts may employ theories other than the fiduciary principle which would prevent an insider from trading options on inside information with impunity.

1. The Misappropriation Theory

The Second Circuit has used the misappropriation theory to expand insider trading liability beyond the reach of the fiduciary principle. Courts have recognized that an employee who misappropriates confidential corporate information has breached his fiduciary

222. See Chiarella, 445 U.S. at 230. A fiduciary relationship could not have been created from the circumstances of the trade itself. The OCC, acting as an intermediary for all options transactions, precludes dealings between the parties. See supra notes 196-98 and accompanying text: Likewise, the trade's execution on an impersonal exchange supports the conclusion that it was nothing more than an at-arm's-length business transaction. In such a transaction, neither party has a duty to disclose to the other absent some fiduciary relationship. See Chiarella, 445 U.S. at 239-40 (Burger, C.J., dissenting).
223. In this hypothetical, there could be no criminal liability, no civil penalties, and no private liability. This Note, throughout its entirety, has demonstrated that the Supreme Court has repeatedly limited Rule 10b-5 liability. See, e.g., Chiarella v. United States, 445 U.S. 222 (1980) (duty to disclose arises not from mere possession of inside information, but from fiduciary relationship between parties to transaction); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (only conduct involving manipulation and deception violates Rule 10b-5); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (limiting standing to purchasers and sellers of securities). In Chiarella, the Court espoused too narrow a view of the duty of disclosure. It is doubtful that the Court intended to create the loophole, but the fiduciary principle does just that. See supra notes 219-23 and accompanying text.
224. See supra notes 109-12 and accompanying text.
duty to the corporation. This breach has been held to constitute a fraud within the meaning of Rule 10b-5, and will support a conviction under the Rule. In the hypothetical above, D misappropriated the information regarding the takeover bid; therefore, under the misappropriation theory, he would be criminally liable under Rule 10b-5.

In Carpenter v. United States, the Supreme Court upheld a conviction based on the misappropriation theory. The misappropriation issue, however, was decided by a divided Court. While Carpenter thus provides no binding precedent in favor of the misappropriation theory, it leaves intact those Second Circuit decisions that advance the theory.


226. See Materia, 745 F.2d at 203.

227. See, e.g., Carpenter, 791 F.2d at 1036 (Second Circuit upheld convictions based on misappropriation theory).


229. Id. at 320.

230. Id. In Carpenter, defendant Winans misappropriated confidential information, to be published in a daily newspaper column, from his employer, the Wall Street Journal. Id. at 319. Winans tipped certain information, before publication, to other defendants who traded on the information. Id. The defendants were convicted for violations of Rule 10b-5, under the misappropriation theory, and sections of the federal mail and wire fraud statutes. United States v. Winans, 612 F. Supp. 827, 850 (S.D.N.Y. 1985), aff’d, 791 F.2d 1024 (2d Cir. 1986), aff’d, 108 S. Ct. 316 (1987). The convictions were affirmed by the Second Circuit, Carpenter, 791 F.2d 1024, 1036 (2d Cir. 1986), aff’d, 108 S. Ct. 316 (1987), and the Supreme Court granted certiorari. Carpenter v. United States, 107 S. Ct. 666 (1986). The Justices split 4 to 4 on the misappropriation issue. They therefore upheld the Rule 10b-5 convictions without opinion. Carpenter, 108 S. Ct. at 320. The Court, however, unanimously affirmed the mail fraud convictions, such affirmance constituting the opinion. Id.

231. See Taylor, Justices, 8-0, Back U.S. on Conviction of Wall St. Writer, N.Y. Times, Nov. 17, 1987, at A1, col. 6 [hereinafter Justices Back Conviction]; see also id. at D11, col. 5 ("the deadlock on the securities fraud issue leaves open the possibility that the Court may someday, in some other case, reject the Government’s broad ‘misappropriation’ theory"); see also J. NOWAK, R. ROTUNDA & J. YOUNG, CONSTITUTIONAL LAW § 2.5, at 33 (1986) [hereinafter NOWAK & ROTUNDA].

Commentators have recognized the weakness of the Carpenter decision and have urged legislation that would codify the misappropriation theory. See, e.g., Nash, ‘Insider’ Definition in New Law Urged, N.Y. Times, Nov. 17, 1987, at D10, col. 2 (Senator Alfonse D’Amato, co-sponsor of insider trading bill, stated on day Carpenter decision was handed down, “[Carpenter] is hardly a ringing endorsement of the S.E.C.’s misappropriation theory. We need a [statutory] definition [of insider trading] more today than yesterday”). A proposed amendment to the Exchange Act would codify the misappropriation theory and thereby enable the government...
Although the misappropriation theory is effective in providing criminal liability for insider trading in options, it does not provide a remedy for option traders. The theory does not impose a duty of disclosure on the violator; therefore, the option trader cannot prove that a fraud was perpetrated upon him.233

2. The Shapiro Rule

The Shapiro rule234 is similar in reasoning to the misappropriation theory but includes a duty of disclosure. D would be both criminally and civilly liable under the Shapiro rule. By breaching his fiduciary duty to X Co., D, by his trade, has committed a fraud in connection with the purchase of a security. He may therefore be held criminally liable for his misappropriation and trade.235 Shapiro adds to the misappropriation theory the separate duty to disclose the inside information or abstain from trading in the corporation's securities. This duty is owed to the entire investing public.236 Recovery, however, is limited to those members of the investing public who can show causation—that is, those who traded contemporaneously with the insider.237 P is certainly a member of the investing public; moreover,
by trading options during the period of D's option trading, he has traded contemporaneously with D.

This line of reasoning was recently endorsed by two federal district courts in decisions regarding claims by option traders against insider traders. These courts distinguished Chiarella and embraced Shapiro in order to prevent the injustice of allowing both the violator to escape civil liability and the plaintiff's injury to go unredressed.

Courts have criticized the Shapiro rule, yet it remains the most effective authority for policing insider trading in options transactions. Congress has expressed concern over insider trading in options through its enactment of ITSA. Preliminary drafts of ITSA expressly pro-


Other courts have refused to adopt Shapiro in lieu of Chiarella's fiduciary principle, and as such, have denied option traders a remedy against insider traders. See, e.g., Laventhal, 704 F.2d at 411; In re McDonnell Douglas Corp. Sec. Litigation, 567 F. Supp. 126, 127 (E.D. Mo. 1983).

239. In a rehearing of O'Connor, the District Court for the Southern District of New York distinguished Chiarella and the Second Circuit case Moss, which also embraces the fiduciary principle. The court contended that the fiduciary principle was meant only for cases involving persons other than traditional corporate insiders. See O'Connor, 600 F. Supp. at 703-04. The court then applied Shapiro. Id. at 703.

In Bianco, the District Court for the Northern District of Illinois distinguished Chiarella in the same manner as O'Connor. See Bianco, 627 F. Supp. at 163. The court then cited O'Connor's interpretation of the Shapiro rule in denying defendants' motion to dismiss. Id. at 164.


One commentator has noted, "there is no logical reason why a trade by the defendant should create such an immense quasi-Samaritan obligation. The trade does not create any relationship with all other investors." Wang, supra note 6, at 1262 (emphasis in original). It should also be noted, however, that the Shapiro concept of a broad duty is properly limited by causation. See supra notes 141-42 and accompanying text. The common law negligence doctrine has endured through many more years of criticism using the similar concept of duty limited by proximate cause. See generally W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser & Keeton on the Law of Torts §§ 28-45, at 160-321 (1984).

241. See generally H.R. Rep. No. 355, supra note 1, at 2295-96. In the legislative
vided for sanctions against insider traders of options and other enumerated securities.\textsuperscript{242} Presently, ITSA simply addresses insider trading of any security,\textsuperscript{243} the definition of which includes options.\textsuperscript{244} A strict application of the fiduciary principle, however, would leave ITSA powerless against insider trading in options. ITSA’s civil money penalty provision is implicated only when there has been a violation of the Exchange Act.\textsuperscript{245} Only \textit{Shapiro} or the misappropriation theory can adequately arm ITSA against options fraud. The SEC, in administrative decisions, has also expressed a policy of discouraging insider trading in options.\textsuperscript{246} In light of these policies, courts should assist in punishing insider traders who exploit the options market. They can best do so by adopting the \textit{Shapiro} rule.

\section*{VI. Conclusion}

The Supreme Court once proffered that “Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed ‘not technically and restrictively, but flexibly to effectuate its remedial purposes.’”\textsuperscript{247} Since that time, however, the Court has done much to contradict itself.\textsuperscript{248} The fiduciary principle is a prime example. Although it is highly unlikely that the Court intended to create an insider trading loophole, it has indeed done so in the area of option trading. Unquestionably, allowing insiders to exploit the

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244. \textit{See 15 U.S.C. § 78c(a)(10) (1982). Presumably, the change in the language of ITSA was made upon amendment of the definition of “security” under the Exchange Act.}
248. \textit{See supra note 223.}
\end{flushright}
options market at the expense of innocent investors is unjust. Courts should therefore attempt to close the option trading loophole by imposing official sanctions on violators through the misappropriation theory and should further permit private Rule 10b-5 actions by adopting Shapiro's duty to disclose inside information to the investing public. Subjecting violators to criminal and civil liability would be both desirable and fair, for the securities laws were meant to protect the public from those who would use inside information for their own advantage.\footnote{249}

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\footnote{249. \textit{See H.R. Rep. No. 1383, supra note 14, at 13.}}