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Fraud, Fiduciaries, and Insider Trading

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One of the constant themes in the voluminous literature about Rule 10b-5 has been the search for a satisfactory theory of liability for insider trading. Is the ban on trading on the basis of material nonpublic information intended simply to provide federal enforcement of the fiduciary obligations of corporate officials? Is it intended indirectly to compel full disclosure in order to facilitate more efficient allocation of resources in the securities markets? Is it intended to provide fair treatment of investors by giving them equal access to material information about publicly traded securities? Is it intended to protect the property rights that corporations have in confidential information? Is it intended to remove the incentive for scalping and other forms of market manipulation by those in control of valuable information? Or is insider trading simply a specialized form of common law misrepresentation? Courts and commentators have at one time or another suggested all of these reasons for imposing a dis-


1. 17 C.F.R. § 240.10b-5 (1981). Rule 10b-5 provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud,
   (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
   in connection with the purchase or sale of any security.

Id.

close-or-abstain rule on those persons in possession of material non-public information, but no single theory has ever prevailed as the overriding reason for the rule. Uncertainty about the underlying rationale for the ban on insider trading necessarily results in uncertainty about the rule’s potential scope. Clearly, for example, a rule intended to equalize investor access to material information would have a much broader scope than one intended simply to prevent misrepresentation or to promote enforcement of traditional fiduciary obligations.

In Chiarella v. United States, the Supreme Court has indicated, with what some may regard as “a foolish consistency,” that the sole purpose of the Rule 10b-5 ban on insider trading is to prevent misrepresentation in connection with securities transactions. While the Court has held in other contexts that Rule 10b-5 bars fraud and only fraud, it appears somewhat surprising for the Court

3. The “disclose-or-abstain” rule is derived from SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971):

[Anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.


6. The Court has consistently held in recent opinions dealing with § 10(b) and Rule 10b-5 that the rule prohibits only fraud, and it has interpreted fraud as synonymous with the traditional common law action of deceit. See Aaron v. SEC, 446 U.S. 680, 694-95 (1980) (scienter required for SEC civil enforcement action); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-75 (1977) (breach of fiduciary duty is not fraud); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (scienter required for private action for damages).
to resolve the uncertainty about the scope and meaning of the insider trading rule solely by reference to the common law of misrepresentation, without any discussion of the special purposes and policies of the federal securities laws. Future questions about the scope of Rule 10b-5 are apparently to be resolved by recourse to Prosser on Torts.

The facts in Chiarella are quite simple. Vincent Chiarella was employed as a "markup man" by Pandick Press in 1975 and 1976, during which period he worked on documents involving five corporate takeover bids. Although the documents were coded, Chiarella was able in each case to decipher the code, identify the target corporation, and purchase stock of the target before public announcement of the takeover bid. After each bid was announced, he sold his recently purchased stock, netting over $30,000 in fourteen months by trading in stock of the five target corporations. Chiarella's activities became the subject of an investigation by the Securities and Exchange Commission, and he subsequently entered into a consent decree requiring disgorgement of his profits. He was also discharged by his employer. He was then indicted and convicted of violating Rule 10b-5 by trading on the basis of nonpublic information about the planned takeover bids.

In affirming his conviction, the Court of Appeals for the Second Circuit held that "[a]nyone--corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling." In so holding, the Second Circuit reaffirmed its earlier statement in SEC v. Texas Gulf Sulphur Co. that Rule 10b-5 is "based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." The Second Circuit found that those who, like Chiarella, "occupy strategic places in the market mechanism" must be barred from using nonpublic information for personal gain because of the unfair advantage the possession
of such information gives them over those with whom they deal.18

The Supreme Court reversed Chiarella's conviction because it concluded that, however improper his behavior, he was not guilty of fraud in the traditional sense.15 Rule 10b-5 may be a catchall provision, stated the Court, "but what it catches must be fraud."14 Citing the Restatement of Torts, the Court concluded that

one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."16

Failure to disclose by corporate insiders, noted the Court, is fraud because of their fiduciary obligation to the corporation's shareholders.16 Chiarella, on the other hand, had no relationship with the target shareholders from whom he bought stock: "He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions."17 Since Chiarella had no apparent duty to the sellers of stock, his silence was not fraud.

The only basis for convicting Chiarella of fraud, therefore, would be to find him subject to a newly created duty to all participants in the market to disclose material nonpublic information or refrain from trading. In the absence of explicit evidence of congressional intent to impose such a duty under section 10(b), the Court declined to depart from "the established doctrine that duty arises from a specific relationship between two parties."18 The majority opinion declined to consider an alternative theory of liability based on Chiarella's misuse of confidential information obtained from his employer.19 Although four Justices in concurring and dissenting opinions indicated that use of misappropriated information in securi-

12. Id.
14. Id. at 234-35.
15. Id. at 228 (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).
16. Id. at 226-29.
17. Id. at 232-33.
18. Id. at 233.
19. Id. at 236.
ties transactions could constitute fraud under Rule 10b-5, the majority held that the jury had been given instructions only on the erroneously formulated “duty-to-the-market” theory and that Chiarella’s conviction had therefore to be reversed.

20. Id. at 239 (Brennan, J., concurring in the judgment), id. at 240-41 (Burger, C.J., dissenting), id. at 252 (Blackmun, J., joined by Marshall, J., dissenting).

21. Id. at 236-37. A subsequent case has clearly posed the misappropriation theory. In United States v. Courtois, 1981 Fed. Sec. L. Rep. (CCH) ¶ 98,024, at 91,287 (S.D.N.Y. June 5, 1981), a federal district court rejected the misappropriation theory as incompatible with the Supreme Court’s reasoning in Chiarella. In a decision rendered after this article was completed, but before it went to press, the United States Court of Appeals for the Second Circuit reversed the district court, holding that a fiduciary’s use of misappropriated confidential information to buy or sell securities could support a criminal conviction for insider trading under Rule 10b-5. United States v. Newman, 1981 Fed. Sec. L. Rep. (CCH) ¶ 98,332, at 92,049 (2d Cir. Oct. 30, 1981), rev’d United States v. Courtois, 1981 Fed. Sec. L. Rep. (CCH) ¶ 98,024 (S.D.N.Y. June 5, 1981). The Courtois case, reversed under the name United States v. Newman, involved somewhat similar facts to Chiarella. The defendant in question, Newman, was a tipppee of persons employed by investment banking firms who were representing acquiring firms in tender offers. Newman and his tippers set up dummy accounts through which they purchased stock in the target companies and then sold the stock at a profit after the tender offers were announced. The district court held that misuse of confidential information was a simple breach of fiduciary duty and did not constitute fraud under Rule 10b-5. 1981 Fed. Sec. L. Rep. (CCH) at 91,290 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 474 (1977)). Moreover, any fraud perpetrated on the investment bankers or their corporate clients was not perpetrated on them as buyers or sellers of securities, as required by the securities laws. Id. at 91,296.

The Second Circuit, in reversing the district court, rejected the district court’s argument that Rule 10b-5 prohibits only fraud perpetrated against buyers and sellers of securities. The court argued that the buyer-seller limitation applies only to private actions for damages and not to criminal actions or suits for injunctive relief. With respect to the more fundamental question whether misappropriation of confidential information itself constitutes fraud and deceit, the court concluded without much discussion or analysis that the misappropriation was fraud, and “not simply internal corporate mismanagement.” 1981 Fed. Sec. L. Rep. (CCH) at 92,052.

In concluding that misappropriation of confidential information constituted fraud within the meaning of Rule 10b-5, the Second Circuit relied on three arguments. First, quoting Justice Burger’s dissent in Chiarella, 445 U.S. at 245 (Burger, C.J., dissenting), the court stated that the wrongdoing was comparable to a theft of cash or securities, in which case “it could hardly be argued that those companies had not been defrauded.” Id. at 92,052. Second, the court stated that the defendants “wronged” the corporate clients seeking to acquire the target companies because their insider trading may have driven up the price of the target companies, thus making the tender offers relatively less attractive. Id. Third, the court pointed out that misappropriation of confidential information by fiduciaries is “unlawful” in other areas of the law, and the court doubted whether “Congress intended to establish a less rigorous code of conduct under the Securities Acts.” Id.

While all three arguments would be relevant if the issue posed by the case were whether or not the challenged conduct was wrongful, none of them is directly relevant to the issue posed by Chiarella—whether insider trading constitutes fraud in the absence of a fiduciary relationship between the parties to the transaction. The Second Circuit nowhere addresses that issue and indeed nowhere discusses the significance of the majority opinion in Chiarella in resolving the issue before it. Thus, while it is clear after Newman that the Second Circuit is
Although some of the language in the majority opinion might suggest a less sweeping reading of Chiarella, the main thrust of the opinion appears to be that Rule 10b-5 prohibits only behavior which would constitute actionable misrepresentation as a matter of common law tort doctrine. That is, the Court suggested that the term "deceptive" as used in section 10(b) and "fraud" as used in Rule 10b-5 are synonymous with the old common law cause of action of deceit. In determining the scope of the insider trading rule, therefore, the only question will now be whether the person trading on the basis of material nonpublic information has by his silence deceived those with whom he traded.

Although the Chiarella opinion raises a number of questions, this article focuses on the Supreme Court's attempt to limit the scope of insider trading liability by equating the established disclose-or-abstain rule with common law misrepresentation. The Court's implicit reasoning appears to be as follows: We have already established that, according to congressional intent, Rule 10b-5 prohibits only fraud. We have also already established that by "fraud" Congress meant the traditional common law action of deceit, rather than any broader concept that would encompass equitable fraud, negligent misrepresentation, or breach of fiduciary duty. Deceit is limited to affirmative misrepresentations of material fact, or to silence when there is a duty to disclose. The existence of a duty to disclose depends on a preexisting fiduciary or confidential relationship between the parties to the transaction. Since, at least in open-market transactions, insider trading necessarily involves only silence rather than affirmative misrepresentations, liability for insider trading will be imposed only in those cases involving a preexisting fiduciary or

willing to impose liability under Rule 10b-5 for trading on the basis of misappropriated confidential information, the Second Circuit has hardly made a persuasive case that its holding is consistent with the Supreme Court's reasoning in Chiarella.

22. One can argue that the result in Chiarella can be attributed to Chiarella's use of market rather than corporate information. See note 94 infra. The Court did seem to suggest that any improper acquisition of corporate information may create a duty to disclose that renders silence fraud. See text accompanying notes 87-95 infra.

23. See note 6 supra.

24. In Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-77 (1977), the Court rejected the theory that breach of fiduciary duty absent deception could constitute fraud, relying heavily on analysis of the statutory language. In Aaron v. SEC, 446 U.S. 680, 690-94 (1980), the Court rejected a rather persuasive argument by the dissent that a showing of scienter was not historically necessary in suits for equitable relief, id. at 709 (Blackmun J., dissenting), and held that the language of § 10(b) required a showing of scienter even in suits by the SEC for injunctive relief. Id. at 691.
confidential relationship between the parties. At each step along the way of the Court’s reasoning, one can both question the validity of the Court’s legal analysis and question whether the results apparently required by the analysis are sensible, consistent with well-established case law, and consistent with the policies of the securities laws. This article first discusses the Court’s reliance on a very narrow concept of fraud in interpreting the application of Rule 10b-5 to insider trading. The Court’s narrow definition seems inconsistent with congressional intent, with prior interpretations of the insider trading rules, with modern developments in the law of misrepresentation, and with general intuitive feelings about the “wrong” associated with insider trading.

The Chiarella opinion also raises the question of how a theory of insider trading liability based on notions of misrepresentation can be reconciled with application of the disclose-or-abstain rule to traditional corporate insiders and their tippees, particularly in the context of open-market trading. The Court seems on the one hand to approve earlier decisions holding insiders and tippees liable for insider trading on the stock exchange, and on the other hand, to incorporate into Rule 10b-5 the required elements of misrepresentation. The requirements of misrepresentation law are in many respects inconsistent with traditional insider trading liability, and this article explores some of those inconsistencies.

As the Court itself implicitly notes in Chiarella, the prohibition on insider trading is not inspired solely or primarily by a desire to prevent deception of individual investors. Both the traditional case law and recent articles articulate a number of concerns embodied in Rule 10b-5: concerns about the integrity of the market process, fairness to individual investors, enforcement of fiduciary obligations, prevention of price manipulation, and promotion of full disclosure to ensure efficient allocation of capital. These concerns are consistent with both the original congressional intent and with the current understanding of the policies of the securities laws. The duty to disclose or abstain may have roots in the common law, but its content and scope are derived from the securities laws themselves. If one interprets Rule 10b-5 in light of the above concerns, they appear to be best accommodated by a rule that imposes the disclose-or-abstain obligation in open-market transactions on corporate insiders and

25. See text accompanying notes 29-56 infra.
26. See text accompanying notes 47-54 infra.
27. See note 5 supra.
their tippees, and on market professionals like broker-dealers and investment advisers who deal regularly and directly with investors. Under the interpretation of the insider trading rule suggested by this article,\textsuperscript{28} the result reached in \textit{Chiarella} is correct, but not for the reasons suggested by the Supreme Court.

\textbf{"Fraud" and Rule 10b-5}

In reversing \textit{Chiarella}’s conviction, the Supreme Court held that Chiarella may have been a faithless employee, but that he had not committed "fraud."\textsuperscript{29} Although the Court generally used the term "fraud" rather than "deception" or "misrepresentation," it seems clear from the Court’s discussion and from its prior holdings with respect to Rule 10b-5 that by "fraud" the Court meant common law deceit rather than a broader concept of fraud that might encompass equitable or constructive fraud, and negligent or innocent misrepresentation.\textsuperscript{30} The Court’s equation of a major antifraud provision of the securities laws with a fairly technical body of tort doctrine seems inappropriate in a number of ways.

\textit{Congressional Intent}

The Court purported to rely on congressional intent in equating Rule 10b-5 with traditional misrepresentation.\textsuperscript{31} As the Court itself acknowledged, however, the legislative history relative to section 10(b) is extremely slight, and, to the extent it indicates anything, suggests that Congress was concerned with market manipulation rather than misrepresentation when it enacted section 10.\textsuperscript{32} Although

\textsuperscript{28} See text accompanying notes 133-139 infra.

\textsuperscript{29} See 445 U.S. at 224-37.

\textsuperscript{30} 445 U.S. at 228 n.9. In defining fraud, the Court cited the Restatement (Second) of Torts and an article defining and discussing the law of misrepresentation. \textit{Id.} (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976); James & Gray, Misrepresentation (pt. 2), 37 Md. L. REV. 488, 523-27 (1978)); see notes 6, 24 supra.

\textsuperscript{31} Although the Court acknowledged that "neither the legislative history nor the statute itself affords specific guidance for the resolution of this case," 445 U.S. at 226, it went on to state the requirements of traditional misrepresentation law and ultimately concluded that a departure from "established doctrine [citing tort law sources] should not be undertaken absent some explicit evidence of congressional intent." \textit{Id.} at 233 (footnote omitted). Although there may be no specific evidence of congressional intent with respect to insider trading liability, there is ample evidence that Congress intended in the antifraud provisions of the securities laws to relax the requirements of common law fraud. See, e.g., Norris & Hirshberg Inc. v. SEC, 177 F.2d 228, 233 (D.C. Cir. 1949); 3 L. Loss, SECURITIES REGULATION §§ 1435-1436 (2d ed. 1961); \textit{Id.} §§ 3535-3537 (Supp. 1969). See also McClure v. Borne Chem. Co., 292 F.2d 824, 834 (3d Cir. 1961).

\textsuperscript{32} See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1975); Dooley, \textit{supra} note 2,
there is substantial evidence that Congress was concerned with common law fraud when it enacted the securities laws generally, it is commonly acknowledged that the securities laws were intended to create broader remedies than those available at common law. Moreover, the legislative history of the securities laws indicates that Congress believed strongly that the securities laws could appropriately be used to deter unethical and undesirable practices in the securities markets in order to protect investors and enhance investor confidence. Reliance on evidence of specific congressional intent with respect to section 10(b) would therefore suggest that the Court should eliminate all liability for insider trading except to the extent it could be regarded as a form of price manipulation, while a broader view of Congress' intent would suggest that insider trading could appropriately be prohibited as part of the SEC's general mandate to promote full disclosure, protect investors, and improve the ethical tone of the securities markets.

In assessing the Court's reliance on congressional intent in Chiarella, it is impossible to resist quoting at some length from the Court's own earlier discussions of the scope of Rule 10b-5. In Blue Chip Stamps v. Manor Drug Stores, the Court held that only purchasers or sellers of securities had standing to sue for damages under Rule 10b-5. The Court conceded that the legislative history gave little guidance on the intended scope of the rule:

Having said all this, we would by no means be understood as suggesting that we are able to divine from the language of § 10(b) the express "intent of Congress" as to the contours of a private cause of action under Rule 10b-5. 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. Such growth may be quite consistent with the congressional enactment and with the role of the federal judiciary in interpreting it, . . . but it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942 foreordained the present state of the law with respect to Rule 10b-5. It is therefore proper that we consider, in addition to the factors already discussed, what may be described as policy considerations when we come to flesh

at 56-59.

33. See authorities cited note 31 supra.
36. Id. at 754-55.
out the portions of the law with respect to which neither the con-
gressional enactment nor the administrative regulations offer con-
clusive guidance.\textsuperscript{37}

The Court added that

we are not dealing here with any private right created by the ex-
press language of § 10(b) or of Rule 10b-5. No language in either of
those provisions speaks at all to the contours of a private cause
of action for their violation . . . . We are dealing with a private
cause of action which has been judicially found to exist, and which
will have to be judicially delimited one way or another unless and
until Congress addresses the question.\textsuperscript{38}

Everything the Court said in \textit{Blue Chip Stamps} about the general
scope of the implied private right of action under Rule 10b-5 is even
more true for the judicially developed ban on insider trading. The
Court’s purported reliance on legislative intent in \textit{Chiarella} thus
stands criticized by its own earlier words.

\textit{Prior Interpretations of Rule 10b-5}

Justice Blackmun, in his ‘dissent in \textit{Chiarella}, appropriately
pointed out that the majority’s opinion concentrated exclusively on
the relationship between buyer and seller and ignored the continued
emphasis in earlier case law and administrative rulings on the
trader’s privileged access to information and his duty to the corpo-
ration that is the subject of the information.\textsuperscript{39} Both \textit{Speed v. Trans-
america Corp.},\textsuperscript{40} and \textit{Cady, Roberts & Co.},\textsuperscript{41} for example, focus on
the relationship between the trader and the information source, not
the relationship between the trader and the opposite party to the
transaction.\textsuperscript{42} It is the improper use of information obtained for a
 corporate purpose that contributes largely to the perception that the
ignorant party to the transaction is being treated unfairly, not solely
the trader’s owing some special duty to the individual with whom he
or she trades. In his recent and persuasive analysis of the back-
ground and meaning of the insider trading rules, Professor Brudney
finds the question of “access” so central to the meaning of the rule

\begin{itemize}
  \item \textsuperscript{37} \textit{Id.} at 737 (citation omitted).
  \item \textsuperscript{38} \textit{Id.} at 748-49.
  \item \textsuperscript{39} 445 U.S. at 249 (Blackmun, J., dissenting).
  \item \textsuperscript{40} 99 F. Supp. 808, 828-29 (D. Del. 1951).
  \item \textsuperscript{41} 40 S.E.C. 907, 912 (1961).
  \item \textsuperscript{42} For a discussion of these two cases, see United States v. Chiarella, 588-F.2d 1358,
  1373-74 (2d Cir. 1978) (Meskill, J., dissenting).
\end{itemize}
that it became the keystone of his theory of insider trading liability.\textsuperscript{43} He argues that the ban on insider trading should apply whenever one person has access to material, nonpublic information that is not legally available to other market participants.\textsuperscript{44} It is thus in large part the source of the information, not some preexisting duty to individual traders, that creates the duty to disclose or abstain.

The majority opinion in \textit{Chiarella} ignored that consistent focus in interpretations of Rule 10b-5 on the relationship between the trader and a third party or third parties to whom a duty is owed. The third party may be the corporation to which the information relates, all the shareholders of that corporation, the clients of a broker or investment adviser, a governmental body, or others who have a legitimate expectation that information acquired by the trader from them or on their behalf will not be used for his or her personal benefit.\textsuperscript{45} The trade may in some sense “deceive” the other party to the transaction, but the element of deception is prominent only in those cases involving face-to-face transactions. Prior interpretations involving open-market trading have emphasized the violation of a more general obligation.\textsuperscript{46}

\textbf{Modern Misrepresentation Theory}

Although the Court appeared to be determined in \textit{Chiarella} to incorporate the common law of misrepresentation wholesale into the securities laws, it did not acknowledge that, under the modern law of misrepresentation, the existence of a duty to disclose is not limited to situations involving preexisting fiduciary relationships.\textsuperscript{47} In a number

\begin{itemize}
\item \textsuperscript{43} Brudney, \textit{supra} note 2, at 353-59.
\item \textsuperscript{44} \textit{Id.} at 353-61.
\item \textsuperscript{46} \textit{E.g.,} Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974):
\begin{quote}
To hold that Section 10(b) and Rule 10b-5 impose a duty to disclose material inside information only in face-to-face transactions or to the actual purchasers or sellers on an anonymous public stock exchange, would be to frustrate a major purpose of the antifraud provisions of the securities laws: to insure the integrity and efficiency of the securities markets.
\end{quote}
\textit{See also} Radiation Dynamics v. Goldmuntz, 464 F.2d 876, 890-91 (2d Cir. 1972) (protection of “uninformed outsiders”); Brudney, \textit{supra} note 2, at 343-47.
\item \textsuperscript{47} In his dissent, Justice Blackmun pointed to both the “special facts” doctrine of corporate law, 445 U.S. at 247 (Blackmun, J., dissenting)(citing Strong v. Repide, 213 U.S. 419 (1909)), and to modern developments in misrepresentation law as supporting the view that a duty to disclose is not limited to situations involving a preexisting fiduciary relationship. \textit{Id.} at 247-48 (Blackmun, J., dissenting). The Court in its majority opinion responded by attributing
\end{itemize}
of cases in recent years, courts have recognized that sellers may have a duty to disclose certain material facts to buyers with whom they have had no prior dealings. Most of the cases involve real estate transactions, and the courts often describe the duty to disclose as one involving facts available only to the seller that the buyer would clearly want to know but cannot himself discover. Some courts, however, have suggested that a number of factual elements may be relevant in determining when a duty to disclose arises; one court has described the question of duty as a "flexible" one.

The important characteristic of these cases is not that they have created a new duty to disclose termite infestation in real estate transactions, but that they illustrate that the modern law of misrepresentation has evolved in response to changing expectations about consumer protection and proper and improper bargaining tactics. Where there is a strong policy of protecting consumer expectations, a duty to disclose material facts may be imposed even in the context of an otherwise arms' length transaction. Certainly the federal securities laws are thought to reflect a strong policy of investor protection, and the factors that modern tort cases have found relevant in creat-

the result in Strong v. Repide to the preexisting fiduciary obligation of the corporate insider, 445 U.S. at 228 n.10; it simply ignored Justice Blackmun's discussion of misrepresentation law.


49. E.g., Lingsch v. Savage, 213 Cal. App. 2d 729, 735, 29 Cal. Rptr. 201, 204 (1963): It is now settled in California that where the seller knows of facts materially affecting the value or desirability of the property which are known or accessible only to him and also knows that such facts are not known to, or within the reach of the diligent attention and observation of the buyer, the seller is under a duty to disclose them to the buyer.


52. It is somewhat ironic that the Court in Chiarella cited one part of James & Gray, supra note 30, as authority for the holding that silence is not generally fraud, 445 U.S. at 228 n.9 (citing James & Gray, supra note 30, at 523-27), while an earlier installment of that article points out that various statutes have relaxed the requirements of common law deceit in the interest of consumer protection and characterizes the federal securities laws as "pioneer legislation" in this effort. James & Gray, Misrepresentation (pt. 1), 37 Md. L. Rev. 286, 287-88 (1977).
ing a duty to disclose should not be ignored by the Court in interpreting a federal statutory scheme whose central purpose is full disclosure.

For example, in a recent tort case imposing a duty to disclose in an arms' length transaction, the court stated: “A duty to speak depends upon the relation of the parties, the value of the particular fact, the relative knowledge of the parties, and other circumstances. ... Thus, each case must be individually examined to determine whether a duty of disclosure exists; a rigid approach is impossible.” Given (1) the special access that corporate insiders have to corporate information and that market professionals often have to market information, (2) the “fiduciary aura” surrounding the relationship between corporate insiders and market professionals on the one hand and outside investors or clients on the other hand, and (3) the opportunity of insiders and market professionals to benefit from manipulation of valuable information, imposition of a duty to disclose seems consistent with modern concepts of fraud.

The “Wrong” of Insider Trading

There is a voluminous literature on whether and why insider trading is “wrong”; there is no need to recapitulate the debate here. For our purposes, it is sufficient to note that many people think insider trading is wrong, or unfair, and that few of them would describe that unfairness solely or even primarily in terms of the deception of individual investors. The unfairness is usually described in terms of betrayal of fiduciary responsibilities or abuse of position, or the use of an illegitimate trading advantage. In other words, the intuitive objection to insider trading is based not on the failure to


54. Some lower courts have interpreted Chiarella as allowing a duty of disclosure to be created by the facts of the securities transaction in question. These courts interpreted Chiarella as requiring a relationship of trust and confidence; the courts assumed that a duty can arise from the factual circumstances of the transaction itself. E.g., E.D. Warde & Sons v. Colorado Nat'l Bank, 502 F. Supp. 461, 463-64 (D. Colo. 1980); Marrero v. Banco di Roma, 487 F. Supp. 568, 574-75 (E.D. La. 1980). The Court's opinion in Chiarella, however, seems to suggest that the duty to disclose must arise from a prior relationship. See note 58 infra.

55. For a brief summary of the arguments and citations to the literature, see B. Rider & H. Ffrench, supra note 2, at 1-8.

56. See id.; Brudney, supra note 2, at 343-49; Dooley, supra note 2, at 39-40. But see notes 128, 131 infra.
disclose to a particular individual but on the general practice of using corporate information for personal benefit. Thus, even if the Supreme Court's opinion in Chiarella involved a more thoughtful and policy-oriented application of the law of misrepresentation, it would still somehow miss the point of the general objections to the practice of insider trading.

LIABILITY OF CORPORATE INSIDERS

When the Court adopted a misrepresentation theory of Rule 10b-5 in Chiarella, it clearly wished to limit the scope of the insider trading rule. On the other hand, the Court seemed to go out of its way to cite with approval traditional case law imposing liability on corporate insiders and their tippees, suggesting that the Court wished to preserve the traditional core of insider trading jurisprudence. The Court's misrepresentation theory of Rule 10b-5, however, is simply not consistent with achieving this goal. Under the Court's version of misrepresentation, a duty to disclose arises only when there is a preexisting fiduciary or confidential relationship between the two parties to the securities transaction. Since the Court ap-

57. 445 U.S. at 226-30 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972); Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275 (2d Cir. 1975); General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1968); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968)). At least some lower courts that have applied Chiarella have apparently interpreted the case as being consistent with continued liability for all corporate insiders and tippees. See, e.g., Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 & nn.14-15 (2d Cir. 1980); Xaphes v. Shearson, Hayden, Stone, Inc., 503 F. Supp. 882, 886 (S.D. Fla. 1981); American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 742-43 (E.D. Va. 1980). In Feldman v. Simkins Indus., Inc., 492 F. Supp. 839 (N.D. Cal. 1980), the court held that the corporation's largest single shareholder was not an insider under Chiarella when he was not an officer, director, or controlling shareholder and had no special relationship affording him access to inside information. Since he was not an insider and had no other fiduciary relation to market traders, he was not liable for trading on material nonpublic information. Id. at 844-45.

58. The Court seemed to suggest that the special duty to disclose must arise from some prior relationship and cannot be created by the securities transaction itself. Specifically, the Court noted that the decision in Strong v. Repide, 213 U.S. 419 (1909), was premised on the preexisting fiduciary obligation of a corporate insider and not on the particular circumstances of the transaction in question. 445 U.S. at 228 n.10. The Court elsewhere stated that Chiarella could have no duty based on his relationship with the target's shareholders because he "had no prior dealings with them." Id. at 232. Some lower courts, however, have apparently interpreted Chiarella as permitting the finding of a duty to disclose despite the absence of any prior dealings between the parties. See, e.g., SEC v. Murphy, 626 F.2d 633, 652 n.23 (9th Cir. 1980) (Chiarella apparently interpreted as imposing duty to disclose on stock promoter dealing with prospective purchasers; court relied on language in Chiarella minimizing distinction between corporate fiduciary's duty to existing and prospective shareholders); E.D. Warde & Sons v. Colorado Nat'l Bank, 502 F. Supp. 461, 464 (D. Colo. 1980); Marrero v. Banco di Roma, 487
appeared to interpret Rule 10b-5 as imposing no new or special duty on market participants, the special relationship giving rise to the duty to disclose must be created either by state law or by some provision of federal law other than Rule 10b-5. State law concerning the fiduciary obligations of corporate insiders in connection with individual securities transactions is, however, both unclear and inconsistent. In addition, fiduciary obligations under state law are usually characterized as less onerous and less broad in scope than the obligations imposed on corporate insiders and tippees by traditional Rule 10b-5 jurisprudence. If the Court wishes to stand by a pure misrepresentation theory of insider trading, therefore, it may have to disavow some rather widely accepted law on insider trading.

Liability based on misrepresentation, moreover, usually requires a showing of privity, reliance, and causation. Traditional Rule 10b-5 jurisprudence has virtually eliminated these requirements at least in the context of open-market trading; it is difficult to see how a...
misrepresentation theory of liability can be meaningfully implemented in the open-market context. Finally, both the traditional case law, which the Court appeared to reaffirm, and other cases involving market professionals reflect a primary concern with problems other than deception of individual investors. A shift of emphasis to misrepresentation would leave a number of generally accepted applications of Rule 10b-5 difficult to explain.

The Chiarella Opinion

The Court in Chiarella projects an ambiguous message concerning the crucial issue of whether the duty to disclose that renders silence fraud must be created by some body of law other than Rule 10b-5, or whether Rule 10b-5 itself creates a duty to disclose. That ambiguity is illustrated by the Court’s discussion of Cady, Roberts & Co.63

Cady, Roberts involved the sale of Curtiss-Wright stock by Gintel, a partner in the broker firm of Cady, Roberts, after he received nonpublic information of an impending dividend cut from Cowdin. Cowdin was both a director of Curtiss-Wright, in which capacity he received the information, and an employee of Gintel’s firm. Gintel, the seller, was therefore not himself a corporate insider, but rather a tippee, and he used the information not to buy stock from existing Curtiss-Wright shareholders, but to sell stock on the open market to public investors who may or may not have already been shareholders in the company.64

Two aspects of this case raise the issue of whether the Securities and Exchange Commission was simply enforcing common law fiduciary duties or was imposing new obligations arising from Rule 10b-5. First, under state law corporate officers and directors generally have a fiduciary obligation to existing shareholders but not to prospective shareholders.65 In Cady, Roberts, however, the Commission held that corporate insiders have a special duty not only to existing shareholders, but also to potential buyers of stock.66 In reaching that conclusion, the Commission distinguished between common law fiduciary duties and duties imposed by the securities laws:

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(2d Cir. 1974).

63. 445 U.S. at 226-30.
65. See note 59 supra. This distinction has generally been recognized and applied in other contexts under Rule 10b-5. See note 80 infra.
66. 40 S.E.C. at 913.
Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts. 67

Such an approach, stated the Commission, “is too narrow. It ignores the plight of the buying public—wholly unprotected from the misuse of special information.” 68 The Chiarella Court, however, in discussing Cady, Roberts, did not quote the Commission’s language, which suggests an extension of the common law duties of corporate insiders. Rather, the Court cited the language of an earlier case:

The Commission [in Cady, Roberts] embraced the reasoning of Judge Learned Hand that “the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.” 69

Judge Hand’s rather general language, unlike the more specific language of the Cady, Roberts opinion, can be read as suggesting that state corporation law itself might be interpreted to extend the fiduciary obligations of corporate insiders to potential as well as existing shareholders. The Commission suggested, on the other hand, that the policies of the securities laws and not common law distinctions should determine the duties of corporate insiders under Rule 10b-5. Thus, the Court appears to have interpreted Cady, Roberts as simply enforcing previously recognized common law fiduciary obligations.70

This interpretation is reinforced by the Court’s general characterization of Cady, Roberts and by the authorities the Court cited for that characterization.71 Thus, although Cady, Roberts actually involved the sale of Curtiss-Wright stock by a broker who held no position with Curtiss-Wright to persons who presumably were not shareholders of Curtiss-Wright, the Court described the case as fol-

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67. Id. at 913-14 (footnote omitted).
68. Id. at 913.
69. 445 U.S. at 227 n.8 (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), cert. denied, 341 U.S. 920 (1951)). Gratz involved a challenge to the constitutionality of §16(b) of the Securities Exchange Act of 1934, and was itself cited in a footnote in Cady, Roberts. 40 S.E.C. at 914 n.23 (citing Gratz, 187 F.2d at 49).
70. See text accompanying notes 75-80 infra.
71. See 445 U.S. at 226-29; see authorities cited notes 74 & 75 infra.
lows: “In its Cady, Roberts decision, the Commission recognized a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”72 In a footnote,73 the Court cited two categories of authorities: The first group simply describes the nature of the fiduciary obligation of a corporate director or officer to a selling shareholder under state corporation law.74 The second category consists of three law review articles interpreting Cady, Roberts as involving nothing more than an application by the Commission of the preexisting special facts concept of fiduciary obligation under state law.75 One of the articles, on the page specifically cited by the Court, makes the following statement:

Accordingly, in applying clause (3) [of Rule 10b-5] to an alleged violation, and particularly to one involving nondisclosure, the basis for liability must be clearly established. To the extent that the transaction in Cady, Roberts constituted utilization of inside information by one who was considered a director (because of the relationship between a partner and employee of a brokerage firm) upon whom an affirmative duty of disclosure existed apart from the securities acts, the application of clause (3) is probably justified.76

One cannot read through the cited authorities without getting the very strong impression that the Court interpreted Cady, Roberts as consistent with its own misrepresentation theory of Rule 10b-5. In other words, silence was considered fraud in Cady, Roberts because of the preexisting “relationship of trust and confidence”77 between corporate directors and shareholders, which the Commission simply “recognized” as established by state law under the special facts doctrine.78 The Court thus ignored the distinction between corporate di-

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72. Id. at 228 (footnote omitted).
73. Id. at 228 n.10.
75. Id. (citing Daum & Phillips, The Implications of Cady, Roberts, 17 Bus. LAW. 939, 945 (1962); Note, Rule 10b-5: Elements of a Private Right of Action, 43 N.Y.U. L. REV. 541, 552-53 & n.71 (1968); 75 HARV. L. REV. 1449, 1450 (1962)). Given the enormous literature on Rule 10b-5 generally and Cady, Roberts specifically, the Court seems to have gone out of its way to dip back into the early literature for restrictive interpretations of Cady, Roberts.
77. 445 U.S. at 228.
78. See [3A] W. FLETCHER, supra note 59, at § 1171.
rectors and noninsiders and between present shareholders and potential shareholders, which exists in state fiduciary doctrine\textsuperscript{79} and which has been recognized elsewhere in Rule 10b-5 jurisprudence\textsuperscript{80} in order to find a clear case of common law misrepresentation in Cady, Roberts.

As indicated by the above discussion, the second aspect of Cady, Roberts that might be considered a departure from common law fiduciary obligations is its extension of the ban on insider trading to a person who was not himself a corporate insider, but rather a tippee of a corporate insider. The Commission in Cady, Roberts discussed that factor at length, acknowledging that "a special obligation has been traditionally required of corporate insiders, e.g., officers, directors and controlling stockholders."\textsuperscript{81} The Commission indicated, however, that the obligation was also to be imposed on other persons, based on their access to corporate information and the inherent unfairness of trading on information unavailable to others:

In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our 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 in its securities.\textsuperscript{82}

The Commission concluded that since Cowdin, the Curtiss-Wright director who tipped the selling broker (Gintel), was clearly prohibited from trading on inside information, then "[b]y logical sequence, [Cowdin's relationship to the company] should prohibit Gintel, a partner of registrant,"\textsuperscript{83} from trading on the basis of inside information. In support of its position, the Commission referred to section 201(2) of the Restatement of Restitution which states: "Where a fiduciary in violation of his duty to the beneficiary communicates

\textsuperscript{79} See note 59 supra.
\textsuperscript{80} See, e.g., Lanza v. Drexel, 479 F.2d 1277, 1291-98 (2d Cir. 1973) (common law did not impose on individual corporate directors affirmative duty to disclose material information to prospective purchasers of corporate stock; legislative history of securities laws indicated Congress did not intend to impose any such affirmative obligation under § 10(b)); Greene v. Emersons, Ltd., 1980 Fed. Sec. L. Rep. (CCH) ¶ 97,266 (S.D.N.Y. Jan. 30, 1980) (where fiduciary duty exists, recklessness may satisfy scienter requirement of Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); outside directors, however, owe no fiduciary duty to prospective shareholders and therefore recklessness may not be sufficient).
\textsuperscript{81} 40 S.E.C. at 912.
\textsuperscript{82} Id.
\textsuperscript{83} Id.
confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.”84 The Commission thus suggested a dual reason for holding the tippee, Gintel, liable under Rule 10b-5. It suggested that Gintel, the selling broker, had a special relationship with Curtiss-Wright through his continuing connection with Cowdin, who was simultaneously a director of Curtiss-Wright and a broker employed by Gintel’s securities firm. The Commission also appeared to suggest that the passing of confidential corporate information by a corporate fiduciary to a third party may itself be a breach of fiduciary duty, and that the tippee who profits from that information may be liable because of his participation in the corporate insider’s breach of fiduciary duty to the corporation.

In its discussion of Cady, Roberts, the Chiarella opinion disposed of the tippee issue in a single sentence in a footnote: “Since the insider could not use the information, neither could the partners in the brokerage firm with which he was associated.”85 The Court then went on to discuss the holding in Cady, Roberts as if the case involved trading by the corporate director himself, and not by the broker to whom he had passed the information.86 The Court thus avoided the sticky question raised by the facts of Cady, Roberts: How can a noninsider have a preexisting fiduciary relationship with a nonshareholder; that is, how could Gintel’s silence be fraud under the Court’s reasoning in Chiarella? Later in its opinion, however, the Court addressed the tippee problem in more general terms:

“Tippees” of corporate insiders have been held liable under § 10(b) because they have a duty not to profit from the use of inside information that they know is confidential and know or should know came from a corporate insider. . . . The tippee’s obligation has been viewed as rising from his role as a participant after the fact in the insider’s breach of a fiduciary duty.87

The Court’s discussion of tippee liability suggests that the wrong associated with the tippee’s behavior is not deception of the other party to the trade, with whom of course the tippee typically has no prior

84. Id. (citing Restatement of Restitution § 201(2) (1937)).
85. 445 U.S. at 227 n.8.
86. Id.
87. Id. at 230 n.12 (citing Subcommittees of American Bar Assoc. Section of Corporation, Banking, and Business Law, Comment Letter on Material, Non-Public Information (Oct. 15, 1973)).
relationship. Rather, the wrong is the use of confidential information improperly acquired. Indeed, the ABA Comment Letter cited by the Court explicitly makes that point:

It seems to us that the policy served by extension of liability to tippees and to noninside "insiders" is something apart from promotion of issuer disclosure or fulfillment of investor anticipations. Rather, the policy affecting these groups relates to reinforcement of other, more traditional duties and expectations: breach, or participation in the breach, of obligations or legitimate expectations of confidentiality arising out of business or professional relationships with issuer corporations can be discouraged, without adverse consequences to the general marketplace, by imposition of trading inhibitions upon the persons occupying such relationships, and it may well be appropriate to extend the application of the anti-fraud rules to accomplish that socially desirable purpose.\(^8\)

The Court suggested that insider trading liability is imposed for reasons other than avoiding misrepresentation in transactions with one's beneficiaries. It pointed out that "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."\(^9\) The Court's language and its approval of the result in \textit{Cady, Roberts} both suggest an acknowledgement that Rule 10b-5 is in part intended to prevent unfair behavior by corporate officers and their associates regardless of whether any individual is deceived. If the only wrong involved in insider trading is deception of the ignorant party to the transaction, then surely actionable misrepresentation has not occurred when a tippee trades. The tipper may have a fiduciary obligation to an existing shareholder, but the tippee does not; the tippee enters into a transaction, but the tipper has certainly not deceived anyone by passing on confidential information.\(^9\) The wrong is the misuse of confidential information to take unfair advantage of a public investor; the Court, however, seemed to insist that it was interested only in a breach of a clearly established duty to dis-


\(^{89}\) 445 U.S. at 230.

\(^{90}\) \textit{See Note, From Brophy to Diamond to Schein: Muddled Thinking, Excellent Result,} 1 J. Corp. L. 83, 93 n.109 (1975).
close.91 If failure to disclose is not itself fraud, then no fraud occurs despite other wrongful behavior.92

If the Court were truly concerned only with misrepresentation based on preexisting duty, then it would be indifferent to the nature of the inside information and the manner in which it was obtained. In discussing Chiarella's situation, however, the Court described him as follows:

In this case, the petitioner was convicted of violating § 10(b) although he was not a corporate insider and he received no confidential information from the target company. Moreover, the "market information" upon which he relied did not concern the earning power or operations of the target company, but only the plans of the acquiring company. Petitioner's use of that information was not a fraud under § 10(b) unless he was subject to an affirmative duty to disclose it before trading.93

If Chiarella had a fiduciary obligation to the selling shareholders,

91. As the authorities indicate, see notes 59, 80 supra, courts usually assume that corporate fiduciaries have no general affirmative duty of disclosure to prospective stock purchasers either under state law or under Rule 10b-5. The obligation to disclose in connection with insider trading arises because of the misuse of corporate information, not from any general duty to disclose based on some incipient fiduciary relationship. But see SEC v. Murphy, 626 F.2d 633, 652 n.23 (9th Cir. 1980) (Chiarella interpreted as imposing affirmative duty of disclosure on stock promoter dealing with prospective purchasers).

92. If a showing of fraud requires a preexisting fiduciary relationship, then the question arises whether the disclose-or-abstain rule applies to any insider trading by the corporation, or to transactions involving trading in debt securities rather than equity securities. State law does not generally regard the corporate entity as having a fiduciary relationship to individual shareholders, but only to shareholders as a group. See, e.g., American Gen. Ins. Co. v. Equitable Gen. Corp., 493 F. Supp. 721, 741 (E.D. Va. 1980) (applying Virginia law). Analogously, Professors Bauman and Brudney locate the source of any general duty to disclose by the corporation in the policies of the securities laws and general considerations of fairness, rather than in state corporations law. Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose, 67 Geo. L.J. 935, 943-48 (1979); Brudney, supra note 2, at 346-47. Since fiduciary obligations are imposed for the purpose of controlling individuals whose substantial discretion in acting on behalf of others gives them opportunities to cheat and take unfair advantage of their beneficiaries, the very idea of a fiduciary relationship involving an artificial entity is implausible. See generally Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 U.C.L.A. L. Rev. 738, 757-61 (1978). State law similarly does not usually impose fiduciary obligations on corporate insiders for the benefit of corporate creditors, at least in solvent corporations. See, e.g., Jefferson Pilot Broadcasting Co. v. Hilary & Hogan, Inc., 458 F. Supp. 310, 313 (M.D. Ala. 1978) (applying Alabama law). See generally [3A] W. Fletcher, supra note 59, at § 1180; Loss, The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States, 33 Mod. L. Rev. 34, 46 (1970) (suggesting Rule 10b-5 should possibly be applied to trading in debentures as well as stock despite different relationship between director and shareholder, and director and creditor).

93. 445 U.S. at 231.
then he presumably would be obliged to disclose *any* material information relevant to the transaction, regardless of its source or nature—market information and corporate information are equal in the eyes of a misrepresentation theory of Rule 10b-5.94 The Court's language seems to suggest, however, that receipt of confidential information about the target from the target might have changed Chiarella's status regardless of any other prior relationship with the target shareholders.95 In other words, the Court again appeared to imply, as it did in its allusion to tippee liability, that a duty to disclose to a corporation's shareholders and potential shareholders may be created by the knowing receipt of confidential information from a corporate source. While such a duty is consistent with prior interpretations of Rule 10b-5, it does not seem consistent with a misrep-

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94. Others have interpreted *Chiarella* as reaffirming liability for trading on inside information while negating liability for trading on market information. See, e.g., United States v. Courtois, 1981 FED. SEC. L. REP. (CCH) ¶ 98,024, at 91,291 (S.D.N.Y. June 5, 1981) (interpreting *Chiarella* as holding Rule 10b-5 inapplicable to trading on market information), rev'd sub nom. United States v. Newman, 1981 FED. SEC. L. REP. (CCH) ¶ 98,332 (2d Cir. Oct. 30, 1981); Xaphes v. Shearson, Hayden, Stone, Inc., 508 F. Supp. 882, 886 (S.D. Fla. 1981) (same); Feldman v. Simkins Indus., Inc., 492 F. Supp. 839, 844-45 (N.D. Cal. 1980) (same); Morrison, *Silence is Golden: Trading on Nonpublic Market Information*, 8 SEC. REG. L.J. 211, 221-23 (1980) (same). In its discussion of Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), the *Chiarella* Court seems to cite with approval the result in that case, see 445 U.S. at 229-30, which imposed liability for trading on nonpublic market information. The Court explains the case as one in which a bank had been requested by a corporation to act on behalf of its shareholders; the bank had undertaken to do so, and the shareholders relied on that fact. The bank employees induced stock sales by shareholders without full disclosure, and thereby violated a previously assumed obligation of a fiduciary nature. *Id.* The cases cited in this footnote, like *Chiarella*, involved persons trading on market information who had no prior relationship with those on the other side of the market. *But see* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969). In *Crane*, the court characterized a corporate shareholder as an insider once it had purchased stock in an issuer and was carrying on discussions with its management about a proposed friendly takeover. *Id.* at 796. The court then imposed liability on the insider under Rule 10b-5 for failing to disclose its regular additional purchases of the issuer's stock as part of a scheme to drive off a competing tender offer. *Id.* The information in question was thus market information not derived from any position the shareholder had as an insider.

95. If one focuses on the Court's distinction between market and corporate information, questions are raised about the nature of the "special relationship" that must exist to trigger a duty to disclose. Does the Court mean to suggest that if Chiarella's employer had been retained by the target corporation through its lawyers to print documents containing negative confidential financial information that Chiarella could have been liable for selling stock using that information? Does a printer's assistant retained by the outside lawyers of a corporation have a "special relationship of trust and confidence" with potential shareholders of the corporation? If not, is such a relationship created by his receipt or use of the confidential information? Would Chiarella have the necessary "special relationship" to the target's shareholders if he had simply received confidential information about the target from his cousin who worked as a switchboard operator for the target corporation?
sentation theory of liability based on some duty which preexists the securities transaction itself. Receipt of confidential information by tippees does not at common law appear to create a duty to disclose to those with whom the tippee may deal. The only duty is one owed to the entity or person owning the information, and the remedy is a constructive trust on behalf of the owner. Only if we read state corporation law as holding that anyone improperly acquiring confidential corporate information thereby assumes a fiduciary obligation to each individual shareholder and potential shareholder of the company in question can we make tippee liability consistent with a pure misrepresentation theory of liability for insider trading.

The message in the Court's opinion is ambiguous. Its reliance

96. See James & Gray, supra note 30, at 523-27; Keeton, Fraud—Concealment and Non-Disclosure, 15 Tex. L. Rev. 1, 25-26 (1936) ("Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information, irrespective of the nature of the remedy." (emphasis added)); cf. United States v. Chiarella, 450 F. Supp. 95, 97 (S.D.N.Y. 1978) ("Looking in the other direction, Chiarella's failure to disclose his purloined information to the sellers whose stock he purchased constituted an 'inherent unfairness,' . . . and a 'deceptive device' in connection with his purchases." (quoting Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961))). Although nondisclosure of misappropriated information may be unfair, the law does not seem to have required those possessing it to disclose it to trading partners.

97. See Restatement (Second) of Agency § 312 & Comment c (1957); Restatement of Restitution § 201(2) (1937); 3 A. Scott, The Law of Trusts § 505, at 2428 (1939); cf. Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973) (tippees jointly and severally liable for insider's breach of fiduciary duty), vacated sub nom. Lehman Bros. v. Schein, 416 U.S. 386 (1974). The issue of liability in Schein was subsequently certified to the Supreme Court of Florida, which held that under Florida law third parties would not be liable for the mere receipt and use of confidential information in the absence of evidence that they intentionally caused the initial breach of fiduciary duty. Schein v. Chasen, 313 So.2d 739, 743-44 (Fla. 1975). In Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980), the court held that under Delaware law a fiduciary obligation is not created by mere receipt of confidential information, and therefore use of information for personal benefit is not a breach of a fiduciary duty. Judge Oakes, dissenting, suggested that receipt of confidential information did create a duty not to use it for personal benefit. Id. at 801 (Oakes, J., dissenting). For a general discussion of common law corporate recovery for misuse of confidential information, see Note, Common Law Corporate Recovery for Trading on Non-Public Information, 74 Colum. L. Rev. 269 (1974); Note, supra note 90.

98. This ambiguity is reflected in the variety of interpretations of Chiarella by lower courts. E.g., Huddleston v. Herman & MacLean, 640 F.2d 534, 542 n.10 (5th Cir. 1981) (Chiarella interpreted as requiring showing of common law deceit for Rule 10b-5 liability); Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165 (2d Cir. 1980) (Chiarella interpreted as requiring breach of fiduciary duty, but not necessarily to investor); SEC v. Murphy, 626 F.2d 633, 652 n.23 (9th Cir. 1980) (Chiarella interpreted as imposing duty to disclose on stock promoter dealing with prospective purchasers); United States v. Courtois, 1981 Fed. Sec. L. Rep. (CCH) ¶ 98,024 (S.D.N.Y. June 5, 1981) (relying on Chiarella, court held outsider trading on market information does not violate Rule 10b-5; interpreted Chiarella as inconsistent with misappropriation theory of liability), rev'd sub nom. United States v. Newman, 1981...
on authorities stating the requirements for common law misrepresentation and its interpretation of *Cady, Roberts* as consistent with, if not compelled by, traditional fiduciary obligations under state corporation law both seem to suggest that the duty to disclose required for insider trading liability must be found outside of Rule 10b-5. This interpretation is confirmed by the language the Court used to describe Chiarella:

> No duty could arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.

Yet the Court seemed to approve of the result in *Cady, Roberts* and described the imposition of insider trading liability on tippees with apparent approval. Surely tippees are almost invariably “complete stranger[s] who [deal] with the sellers only through impersonal market transactions,” and yet tippees are apparently subject to the insider trading ban.

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99. 445 U.S. at 229.
100. *Id.* at 226-29.
101. *Id.* at 232-33 (emphasis added).
102. *Id.* at 227-29.
103. *Id.* at 232-33.
104. *Id.* at 230 n.12. In *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980), the Second Circuit held a corporation liable in damages for tippee trading resulting from the improper disclosure of confidential information by one of its officers. Much of the court’s discussion seemed to ignore *Chiarella*; the court characterized the insider trading rule as follows: [Investors who trade on the open market] are, however, entitled to an honest market in which those with whom they trade have no confidential corporate information. . . . It is the combination of the tip and the tippee’s trading that poses the evil against which the open market investor must be protected. . . . The reason for the “disclose or abstain” rule is the unfairness in permitting an insider to trade for his own account on the basis of material inside information not available to others. The tipping of material information is a violation of the fiduciary’s duty but no injury occurs until the information is used by the tippee. The entry into the market of a tippee with superior knowledge poses the threat that if he trades on the basis of inside information he may profit at the expense of investors who are disadvantaged by lack of the inside information.
The Court's apparent distinction between market and corporate information is also inconsistent with a pure misrepresentation theory of Rule 10b-5 unless the improper receipt of confidential corporate information is itself regarded as creating a fiduciary or confidential relationship to individual shareholders of the corporation. Since no such relationship exists under state law, its source must be in Rule 10b-5. The Court's language and its interpretation of Cady, Roberts, however, seem to deny the idea that Rule 10b-5 itself creates new duties or fiduciary obligations.

Insider Trading on the Open Market

If the Court's opinion is ambiguous on the issue of whether Rule 10b-5 creates novel duties concerning the use of corporate information, it completely fails to address the general implications of applying a misrepresentation theory of liability to insider-trading that occurs on the open market. If the real concern of the insider trading rule is preventing deceitful silence, one wonders if the rule should apply to open-market trading at all.

Under state corporation law, it is generally accepted that no disclosure obligation exists when a corporate fiduciary uses inside information to trade on the open market. Although that rule may have been inspired in part by the practical difficulties of matching individual buyers and sellers in stock exchange transactions, a more substantive justification for the rule is the ignorant party's lack of reliance on the fiduciary in entering into the transaction. Silence by a fiduciary is fraudulent primarily because the beneficiary is likely to

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Id. at 169 (citations omitted). Although the court elsewhere cited Chiarella, it characterized the opinion as holding that "there can be no violation of § 10(b) unless the party so charged has violated a duty arising out of a relationship of trust." Id. at 165 n.14. The Second Circuit then concluded, citing Chiarella, that corporate insiders breach their fiduciary obligation when they tip confidential information. Id. (citing 445 U.S. at 229 & n.12). As indicated in the long quotation above, however, it is not the tip but the trade which the court saw as injuring the investor, an injury based on general unfairness. The court, in effect, seemed to have read Chiarella as preserving all the general concerns about unfairness to investors and the wrong of deriving personal profit from confidential corporate information, and simply added a requirement that the transaction must somehow involve a breach of fiduciary duty, although not necessarily to any investor. This seems quite close to the misappropriation theory that the Supreme Court declined to confront in Chiarella and that was later explicitly rejected by a lower court. See note 21 infra. See also Wilson v. Comtech Telecommunications Corp., 1981 FED. SEC. L. REP. (CCH) ¶ 97,970 (2d Cir. Apr. 29, 1981) (general discussion of insider trading without reference to Chiarella).


interpret that silence in a face-to-face transaction as meaning that the fiduciary is aware of no additional material information. In other words, the beneficiary relies on the silence as meaningful because of his trust and confidence in the fiduciary based on their prior relationship.\textsuperscript{107} A misrepresentation theory of insider trading liability is therefore most persuasive in those situations involving face-to-face transactions, where there is privity between the parties, where the ignorant party relies on the insider's silence, and where that reliance demonstrably causes the resulting harm to the ignorant party.\textsuperscript{108} The elements of reliance and causation have been largely eliminated in open-market insider trading cases, however, so that, before \textit{Chiarella}, all that appeared to be required for liability was use of material inside information for personal benefit in a trading transaction.\textsuperscript{109} In other words, it was the trading that was identified as the wrong, not the failure to disclose to some particular individual.\textsuperscript{110} If, however, the Court is serious in indicating that Rule 10b-5 is violated only if some individual is "deceived" in the traditional sense, then meaning can be given to that requirement only if the privity, reliance, and causation requirements of misrepresentation are revived and enforced in the insider trading context.\textsuperscript{111}


\textsuperscript{108} One commentator suggests that face-to-face insider trading should be relegated to state law and that Rule 10b-5 should be confined to insider trading involving publicly held corporations, where "[t]he 'insider' or his 'tippee' who trades on the basis of non-public information is generally not taking unfair advantage of any particular person, but is making unfair use of a public market regulated by a federal agency under federal law." Ratner, supra note 105, at 954. \textit{Chiarella}'s misrepresentation theory would thus limit application of Rule 10b-5 to those cases where the federal interest is least, and bar application of Rule 10b-5 where the federal interest is greatest.

\textsuperscript{109} See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

\textsuperscript{110} This reasoning was evident in Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976), where the Sixth Circuit stated: "We conceive it to be the act of trading which essentially constitutes the violation of Rule 10b-5, for it is this which brings the illicit benefit to the insider, and it is this conduct which impairs the integrity of the market and which is the target of the rule." Id. See also Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 165, 172 (2d Cir. 1980) (trading, not tipping is actionable wrong; investors have no right to confidential information in absence of trading; damages should be measured by tippee's gain, and not by harm, if any, to investors.) For a thorough and persuasive analysis of the causation issue under Rule 10b-5 in the context of open market trading, see Wang, \textit{Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under Rule 10b-5?}, 54 S. CAL. L. REV. 1217, 1230-45 (1981).

\textsuperscript{111} The Court's own emphasis in \textit{Chiarella} on a relationship of trust and confidence "between parties to a transaction," 445 U.S. at 230, and on the absence of "prior dealings"
those requirements would, except in rare cases, eliminate insider trading liability for open-market transactions.\textsuperscript{112}

The Court in \textit{Chiarella} cited with apparent approval the traditional open-market insider trading cases such as \textit{Texas Gulf Sulphur}\textsuperscript{113} and \textit{Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}\textsuperscript{114} In referring to those cases, however, the Court alluded not to the deception of individual investors, but to the wrong of corporate insiders using confidential information for personal benefit. As in its discussion of \textit{Cady, Roberts} and tippee liability generally, the Court seems to approve of using Rule 10b-5 to police the behavior of corporate insiders and tippees whether or not anyone is deceived. But the Court fails to reconcile its approving attitude toward liability for insider trading in the open market with its focus on misrepresentation of individual investors as the evil which Rule 10b-5 was intended to prevent.

\textbf{Rule 10b-5 and Market Professionals}

Although most discussion of insider trading liability focuses on the activities of traditional corporate insiders, a scattering of cases and proceedings have involved imposition of liability under Rule 10b-5 on broker-dealers, investment advisers, and similar market professionals who have traded on the basis of undisclosed material information.\textsuperscript{115} Although most cases, like \textit{Cady, Roberts}, are simply tippee cases, others involve nonpublic information about the operations of the market professionals themselves.\textsuperscript{116} In such cases, application of the disclose-or-abstain rule has the goal and effect of elimi-
nating self-dealing and manipulative practices, rather than simply preventing deception of individuals with a preexisting relationship with the traders in question. The market professional cases emphasize that insider trading is to be prohibited in order to eliminate any incentive to "scalp" or engage in other nefarious practices injurious to the broker's clientele as a whole. After Chiarella, such cases will have to be treated as a separate category not covered by Chiarella; otherwise brokers will either have to be found to have a preexisting duty to all market participants, or will be held liable only where their trading on material undisclosed information happens coincidentally to involve persons who are already their clients.

In trading in the stock of his or her own company, a corporate insider will necessarily be dealing with either a present or a potential shareholder. Requiring a preexisting fiduciary relationship—or a modest extension of such a relationship—thus seems consistent with imposing general liability on corporate fiduciaries for insider trading. If one focuses on the broker-dealer cases, however, one sees that the existence or nonexistence of some prior special relationship between the trader and the ignorant party to the transaction has little or nothing to do with the wrong associated with the broker's actions. His trading is wrong because he is using for personal benefit confidential information acquired or created ostensibly for the benefit of others, and because his ability to engage in such trading gives him an incentive to manipulate prices and delay disclosure of material information. Any deception of an individual party to the transac-

117. E.g., Feldman v. Simkins Indus., Inc., 492 F. Supp. 839, 846 (N.D. Cal. 1980) (Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979), interpreted as involving "active market manipulation and conflict of interest, not mere nondisclosure"). For a discussion of this trend, see Brudney, supra note 2, at 349, 368-71. See generally Courtland v. Walston & Co., 340 F. Supp. 1076 (S.D.N.Y. 1972); Fleischer, Mundheim & Murphy, An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Pa. L. Rev. 798, 824-35 (1973). In Courtland, a stock broker gave some customers advance notice of recommendations which would appear in a later market letter; the court let one such customer sue the broker for his "deceptive practice" despite her participation in the scheme. The court found that "the danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private suits for compensatory damages can have upon brokers and dealers." 340 F. Supp. at 1085 (quoting Pearlstein v. Scudder & German, 429 F.2d 1136, 1141 (2d Cir. 1970)).

118. One commentator has persuasively argued that the various market professional cases really involve market manipulation and are thus explained by § 10(b)'s ban on manipulation of market prices. Note, supra note 4.

119. This concern was expressed by the House of Representatives in their report on § 10(b): "Delayed, inaccurate, and misleading reports are the tools of . . . the recreant corporate official who speculate[s] on inside information." H.R. Rep. No. 1383, 73d Cong., 2d Sess.
tion is tangential to the central wrong.

In the case of the corporate insider, those with whom the insider trades are also those to whom the insider owes a present or potential fiduciary obligation not to abuse his or her position. The individual shareholder may or may not be deceived or harmed as a result of the transaction, but surely he or she has a strong interest as a member of the corporate community in enforcing the insider's fiduciary obligations to the corporation. As the broker-dealer cases suggest, at least in the open-market context, those harmed by insider trading are not solely or always those with whom the insider trades.

INSIDER TRADING: THEORY AND LIABILITY

If one believes that the judicial development of insider trading liability has on the whole been an appropriate development, and that corporate insiders, their tippees, and market professionals generally should be liable for insider trading in either face-to-face or open-market transactions, then one must be uneasy about the misrepresentation theory apparently adopted by the Court in Chiarella. If the Court truly intended to require fraud defined as deception of those specific individuals who deal with inside traders, and if silence can be fraud only where a prior relationship imposes a duty to disclose, then it appears that much traditional law about insider trading is called into question. On the other hand, if the Court did not mean its misrepresentation theory to be interpreted literally, but only intended to eliminate liability for what might be considered peripheral cases of insider trading, the misrepresentation theory is not very helpful in defining what is and what is not peripheral.

A number of questions about insider trading have never been satisfactorily resolved. Who is considered an insider? When is trading on undisclosed market information covered by Rule 10b-5? What is the scope of tippee liability? Different courts and commentators have answered these questions in different ways, but in the

10 (1934). Accord, Brudney, supra note 2, at 335-36. Professor Dooley is not convinced that this fear is legitimate, arguing that there is little evidence in the reported cases of insider trading being associated with delays in disclosure. Dooley, supra note 2, at 33-34.

120. In support of this point, Professor Brudney finds that "it is fair to conclude that a prime function of the disclosure system, including the antifraud provisions, is to prevent a costly breach of fiduciary duty to the corporation and its stockholders, entirely apart from preventing overreaching transactions in the market." Brudney, supra note 2, at 336.

121. For discussions of the strong emphasis on prevention of self-dealing and other misuses of position in traditional Rule 10b-5 case law and commentary, see text accompanying notes 39-46, 55-56 supra and notes 129-131 infra.
absence of a single, complete explanation for the disclose-or-abstain rule, final resolution of these questions is impossible. The Chiarella decision with its ambiguous endorsement of both a misrepresentation theory of liability and some inconsistent prior law has not aided in solving the traditional puzzles. But if the law of misrepresentation is not to supply the theoretical underpinnings for the insider trading rule, what is? If one reviews the case law and the literature concerning insider trading, one can only conclude that no single theory of liability satisfactorily explains all the ramifications of the insider trading rule. A number of different concerns and policies have led courts to a case-by-case development of the law and all of those concerns and policies must be taken into account in defining the scope of the rule. As the Court itself said on an earlier occasion, “[w]e are dealing with a private cause of action which has been judicially found to exist, and which will have to be judicially delimited one way or another unless and until Congress addresses the question.”122 The Court is either naive or disingenuous in purporting to find in misrepresentation doctrine a clear answer to the questions revolving about insider trading liability.

Recent Literature

Several scholars who have recently grappled with the puzzle of insider trading liability have, between them, identified various concerns underlying Rule 10b-5, and have suggested a number of competing theories of liability that in varying degrees accommodate those concerns.123 While the articles in question were completed before the Court decided Chiarella, they deal more directly than did the Court with the issues in that case.

In his lengthy, thorough, and persuasive exegesis of the antifraud provisions of the securities laws generally and the insider trading rule particularly, Professor Victor Brudney describes the legitimate and intended goals of the antifraud provisions as including promotion of full disclosure to ensure efficient allocation of capital, enhancement of investor confidence in the market, protection of investors from overreaching transactions, and enforcement of traditional fiduciary obligations.124 He discusses at some length how the ban on insider trading furthers such goals without imposing significant

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123. See authorities cited note 2 supra.
While he accepts more or less as a given the liability of traditional corporate insiders, he proposes a theory governing imposition of liability on other persons who trade on inside information. He suggests that the policies of the antifraud provisions should lead to a ban on all trading on material nonpublic information by those who obtain such information through "unerodable informational advantages." Such advantages normally arise because an individual holds a position giving him or her access to information not legally available to public investors, no matter how diligently the public pursues such information. Professor Brudney's theory suggests that whenever anyone lawfully acquires confidential information subject to a duty to hold that information confidential, the information may not lawfully be used for securities trading. Under Professor Brudney's theory, Chiarella would be held liable for a violation of Rule 10b-5.

Professor Michael Dooley has also recently canvassed the possible theories supporting liability for insider trading, only to question whether any of these theories justifies enforcement of a general ban on insider trading. While his survey of the case law and his analysis of the high enforcement costs and erratic incidence of enforcement make a strong case for eliminating the rule altogether, one can argue that he simply undervalues the symbolic importance of enforcing a rule that appears to have strong intuitive appeal. For the purposes of this article, the interesting aspect of Professor Dooley's article is his view that the principal objection to insider trading is that it involves "indulging one's self-interest to the point of dishonesty." He contends that outside investors as a group are harmed by insider trading because they perceive inside traders as "too little concerned with their welfare and too willing to act dishonestly to gain advantage." The lack of confidence in corporate insiders is reflected in the market price of corporate stock being discounted, and all investors are harmed by the resulting loss. The "loss of market confidence" that courts frequently discuss in insider trading cases is thus...

125. Id. at 339-53.
126. Id. at 354-56.
127. Id. at 357-58.
128. Dooley, supra note 2. See also Hetherington, When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights, 8 HOFSTRA L. REV. 183, 223-33 (1979) (questioning value of ban on insider trading and arguing that investors generally are indifferent to insider trading).
129. Dooley, supra note 2, at 39.
130. Id. at 40.
reflected in a real loss in wealth by investors.131

Despite the differences in their overall attitudes toward insider trading, Professors Brudney and Dooley agree in characterizing the wrong associated with insider trading as having to do with self-dealing and breach of fiduciary duty toward the corporation or shareholders and clients as a group, rather than with misrepresentation or deception of individual investors. Both also agree implicitly that the persons wronged by insider trading are not primarily those with whom the insider trades. Rather, they are the whole class of shareholders, investors, or clients who reasonably demand that those given access to valuable information for the benefit of others refrain from engaging in self-dealing or using the information to take unfair advantage of those very persons who placed them in their privileged positions.

Despite its emphasis on misrepresentation, the Chiarella decision does not entirely ignore these central concerns of the commentators; certainly misrepresentation is a form of “taking unfair advantage” of investors. Still, the Court’s emphasis on the technical requirements of tort law somehow misses the point of Rule 10b-5.132 One is reminded in reading the Court’s opinion of those 18th-century English judges who refused to accept any claim for legal redress, no matter how apparently meritorious, which did not fit neatly into an accepted writ or form of action. Does the writ system live on in the securities laws? Surely the Congress that spoke in outraged tones in 1933 and 1934 about self-dealing, breach of fiduciary duty, and unethical practices in the securities markets would be somewhat surprised by the Court’s narrow view of the scope of the antifraud provisions.

The Insider Trading Rule—A Suggested Approach

When confronting the gaps and inconsistencies apparent in any judicially developed doctrine, the Court should refer to the history and policies underlying the statutory scheme of which that doctrine is a part. Referring to the history and policies underlying the federal securities laws leads to the conclusion that the ban on insider trading

131. Id. at 41. Dooley goes on to argue that there is little empirical evidence substantiating the existence of significant “investor aversion” to insider trading. Id. at 41-48.
132. See Ratner, supra note 105, at 954: “The ‘insider’ or his ‘tippee’ who trades on the basis of non-public information is generally not taking unfair advantage of any particular person, but is making unfair use of a public market regulated by a federal agency under federal law.”
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was intended not only to enforce traditional corporate fiduciary obligations, but also to broaden those obligations. Congress was concerned with protection of investors, not protection of persons in common law fiduciary relationships. In enacting a scheme of federal securities regulation, Congress intended its antifraud provisions primarily to affect behavior in the securities markets and only secondarily to affect dealings between fiduciaries and individual shareholders.\(^3\) Surely it intended certain provisions to apply to various forms of self-dealing affecting investors as a group whether or not an individual was deceived in the particular transaction. Surely it did not intend to create federal remedies only where state corporation or common law remedies already existed, and to deny federal relief solely on the ground that no fiduciary obligation existed under state law.\(^4\) Congress presumably had federal interests in mind, and these interests focus primarily on the efficient and fair functioning of the organized securities markets as a system, not on occasional instances of individual dishonesty, which could be better dealt with by local law.\(^5\) When the Court itself has so recently and vehemently spoken of limiting the federal courts to enforcement of federal policies and not intruding into areas traditionally governed by state law,\(^6\) its singleminded focus on misrepresentation in *Chiarella* seems somewhat misplaced.

In enacting the securities laws, Congress was concerned about investor protection, about full disclosure, about the efficient and fair

\(^3\) See Anderson, *supra* note 34, at 315-20.

\(^4\) One is reminded of the bizarre developments in lower court Rule 10b-5 jurisprudence arising from footnote 14 of *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475 n.14 (1977). This footnote indicated that alleged nondisclosures in connection with a merger would not be material where shareholders had no available remedy under state law for attacking the merger on fairness grounds and thus could not have done anything even if the alleged "unfairness" had been disclosed. Numerous cases have since held that the availability of a Rule 10b-5 cause of action may depend on whether the complaining shareholders have a remedy under state law, with the ironic result that shareholders with a state remedy can sue under Rule 10b-5 while those with no state remedy are barred from federal court. *E.g.*, *Healey v. Catalyst Recovery, Inc.*, 616 F.2d 641 (3d Cir. 1980); *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273 (9th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209 (2d Cir. 1977). *See generally Ferrara & Steinberg, A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism, 129 U. PA. L. REV. 263 (1980).*

\(^5\) *See Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477-80 (1977); *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418, 439 (5th Cir. 1980) (concern of Rule 10b-5 is not violation of state law but "purity of the securities transaction and the securities trading process"); *O'Brien v. Continental Ill. Nat'l Bank & Trust Co.*, 593 F.2d 54, 59-63 (7th Cir. 1979) (Rule 10b-5 intended to ensure "full and fair disclosure to participants in securities transactions," not redress violations of state law fiduciary obligations).

operation of the securities markets, and about the improvement of ethical standards among professional market participants. Enforcement of the disclose-or-abstain rule furthers these policies in a number of ways: It limits opportunities for self-dealing and thus both promotes investor confidence in the market by raising ethical standards of regular market participants, and protects corporate shareholders and the clients of market professionals by enforcing traditional fiduciary obligations, which have their source in corporate and agency law. It also promotes fair operation of the securities markets by eliminating individual overreaching transactions, and by eliminating a systematic bias in favor of insiders and against outsiders because of a differential access to valuable information. Finally, it removes an incentive for those in control of the creation and release of valuable information to delay its disclosure or to manipulate release of the information in order to manipulate market prices.

Given the above concerns and the effects of enforcing the disclose-or-abstain rule, it makes sense to limit application of the rule to those persons who regularly deal with investors, who have control over the disclosure of corporate and market information, who have regular opportunities for self-dealing at the expense of investors, and who hold themselves out in their profession as acting primarily on behalf of others in connection with investment in securities. Corporate insiders and market professionals such as broker-dealers and investment advisers are the two groups who most clearly satisfy these criteria; I would limit the application of the disclose-or-abstain rule to these two groups. Application of the rule to tippees of the two groups is appropriate simply to eliminate indirect violations of the rule. Was the result in Chiarella correct? I believe so. Although

137. See Anderson, supra note 34; Brudney, supra note 2, at 333-39.
138. Tipping and other forms of indirect insider trading were included in early versions of § 16(b) of the 1934 Act for this reason; such versions were, however, not enacted, presumably because of perceived enforcement problems. One commentator suggests that the provisions would have been included if computers had been better developed at the time. B. RIDER & H. FFRENCH, supra note 1, at 24.
139. In this conclusion I differ from both Professor Brudney, supra note 2, at 357-58, and the Second Circuit, United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978). See also Federal Securities Code § 1603, comment 3(d), at 538-39 (Proposed Official Draft 1978) (rejecting application of disclose or abstain rule to "quasi-insiders" like printers and government officials, but suggesting that "egregious" cases of misbehavior might constitute fraud). Although I agree with most of Professor Brudney's analysis, I believe that in drawing the line between insider trading subject to Rule 10b-5, and insider trading more appropriately regulated under state law fiduciary concepts, the ability to control information and
financial printers do have regular access to confidential information concerning the securities market and thus have the opportunity to benefit themselves in violation of their fiduciary obligations, they do not typically have control over the timing or content of corporate or market disclosure, and they do not typically deal directly with investors or hold themselves out as fiduciaries to the investing public. The ability to trade on inside information thus does not give them either the incentive or the opportunity to manipulate public disclosure of information for their own purposes. Moreover, publicity about self-dealing by printers is not likely to have the same impact on investor confidence as disclosure of self-dealing by those with a more central role in the market. Most importantly, however, a printer’s lack of relationship with investors as a group makes the idea of a duty running to those investors somewhat anomalous. Although the Supreme Court seems wrong in focusing on the relationship between individual buyers and sellers in the context of open market trading, it does seem that the duty imposed by Rule 10b-5 is a duty toward investors and therefore should be limited to those with some general relationship with that group. Corporate insiders and market professionals are hired by investors to act on their behalf, and these insiders and professionals profit by inducing investors to rely on their competence and integrity. Surely that creates an institutional, although not always individual, relationship of trust and confidence that justifies imposing the duty to disclose or abstain on those two groups and their tippees. This relationship also helps us draw a line around Rule 10b-5 which falls short of Vincent Chiarella.

The result in *Chiarella* does not therefore seem incorrect. Some forms of misbehavior involving the securities markets can be adequately and more appropriately policed under common law doctrines of agency and tort law and under state corporation law. But the Court’s discussion in *Chiarella* gives little assistance in solving the broader puzzle of insider trading liability, and its ambiguous dance between preserving liability for corporate insiders and tippees and enforcing the technical requirements of misrepresentation doctrine is positively unaesthetic. The Court appears simply to be playing games with doctrine in order to limit liability without articulating the reasons why liability should be limited in just that way. This is not a Supreme Court construing a complicated federal statutory

securities transactions and the existence of a regular relationship with investors become the most important criteria.
scheme with wisdom, craft, and candor; this is a first-year Torts class on a bad day.