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MISAPPROPRIATION: A GENERAL THEORY OF LIABILITY FOR TRADING ON NONPUBLIC INFORMATION

Barbara Bader Aldave*

The more one ponders the reasoning in Chiarella v. United States¹ and Dirks v. SEC,² the less one is satisfied with the Supreme Court’s explanation of when and why Rule 10b-5³ prohibits trading in securities on the basis of material nonpublic information. Chiarella and Dirks establish that a person violates Rule 10b-5 by buying or selling securities on the basis of material nonpublic information if (1) he owes a fiduciary or similar duty to the other party to the transaction; (2) he is an insider of the corporation in whose

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³ Rule 10b-5 was promulgated under § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1982). Section 10(b) 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 were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1984), provides:

(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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shares he trades, and thus owes a fiduciary duty to the corporation's shareholders; or (3) he is a tippee who received his information from an insider of the corporation and knows, or should know, that the insider breached a fiduciary duty in disclosing the information to him. Fortunately, Chiarella and Dirks need not be read as holding that only a person who owes a fiduciary duty to a particular purchaser or seller, or to a body of shareholders, is barred from trading on nonpublic information. Were the lower courts so to read the cases, they would be obliged to accept a highly arbitrary scheme of liability under Rule 10b-5.5

The "misappropriation theory" offers a better alternative. The Supreme Court has expressly reserved judgment on the misappropriation theory as a basis for imposing liability on "outsiders" who improperly acquire nonpublic information, or convert such information to their own use, in order to take advantage of it in their securities trading.6 This Article argues that the misappropriation theory provides a convincing rationale for finding that outsiders violate Rule 10b-5 when they trade on the basis of nonpublic information that has been entrusted to them with the expectation that they will hold it in confidence and refrain from acting upon it, and that the theory also provides the best rationale for the disclose-or-abstain obligation of insiders and their tippees.

I. THE REASONING OF CHIARELLA AND DIRKS

In Chiarella v. United States the Supreme Court stressed that Rule 10b-5 is directed at fraud, and that "one who fails to disclose material information prior to the consummation of a transaction

4. See infra notes 7-12 and accompanying text.
5. The Chiarella-Dirks analysis does not, for example, reach outsiders—such as employees of investment bankers, financial printers, or government agencies—who have access to confidential market information and take advantage of it in their trading. See infra note 33 and accompanying text.
6. Both Chiarella and Dirks involved trading by outsiders. In Chiarella the government argued, inter alia, that the defendant's conviction could be sustained on the theory that he had violated Rule 10b-5 by misappropriating nonpublic information and purchasing securities on the basis of that information. See infra notes 60-61 and accompanying text. The Supreme Court refused to consider the merits of the misappropriation theory, since it had not been submitted to the jury. Chiarella, 445 U.S. at 235-37. In Dirks, the Court held that a securities analyst had not violated Rule 10b-5 when he passed on to his clients nonpublic information that corporate insiders had supplied to him. 463 U.S. at 665. After finding that the analyst had not breached any fiduciary duty, the Court observed that the insiders did not expect him to "keep their information in confidence," and that he did not "misappropriate or illegally obtain the information." Id.
commits fraud only when he is under a duty to do so.”

Chiarella, a printer’s employee, had exploited his access to confidential documents and bought stock of companies that were to be the targets of takeover bids. Chiarella had no fiduciary or similar relationship to the shareholders of the target companies, but “was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.” Therefore, held the Court, he could not be convicted of violating Rule 10b-5 on the theory that he had defrauded those who had sold stock to him.

In Dirks v. SEC, the Court confirmed that the insiders of a corporation owe a fiduciary duty to the corporation’s shareholders, and therefore are required either to disclose material inside information or to refrain from trading in the corporation’s securities. The Court then held that a tippee who trades on the basis of material nonpublic information disclosed to him by an insider violates Rule 10b-5 if the insider breached a fiduciary duty in making the disclosure, and the tippee knew or should have known of the breach. In determining whether an insider has breached his duty, said the Court, the question is “whether the insider personally will benefit, directly or indirectly, from his disclosure.” Applying these principles, the Court concluded that Dirks, a securities analyst who had obtained information about a fraud within an insurance company from employees of that company, did not violate Rule 10b-5 when he passed on the information to his clients, who then sold their holdings of the company’s securities. Dirks’ informants had not acted for personal gain, but instead had been motivated by the desire to expose a fraud. Since the insiders had not breached a fiduciary duty to the company’s shareholders, Dirks had not been a participant after the

7. Chiarella, 445 U.S. at 228.
8. Id. at 224.
9. Id. at 232-33. The Court explained that it could not affirm Chiarella’s conviction “without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information,” and concluded that it should not formulate “such a broad duty . . . absent some explicit evidence of congressional intent.” Id. at 233.
10. Id. at 234-35.
11. Dirks, 463 U.S. at 653.
12. Id. at 660.
13. Id. at 662. A court is to determine whether there has been a breach by looking to “objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings.” Id. at 664 (citation omitted).
14. Id. at 665.
15. Id. at 667.
fact in any breach, and had not violated Rule 10b-5.16

The *Chiarella-Dirks* emphasis on fiduciary duties reflects the Court's determination that the meaning of "fraud" in Rule 10b-5 is essentially the same as the meaning of "fraud" at common law.17 As developed at common law, the elements of a cause of action for fraud or deceit are the misrepresentation of a material fact, scienter, reliance, causation, and damages.18 A mere failure to disclose material facts, as distinguished from an affirmative misrepresentation or half-truth, is generally not actionable unless one party owes a duty of disclosure to another "because of a fiduciary or other similar relation of trust and confidence between them."19

The basis of the rule that a fiduciary duty creates an obligation of full disclosure appears to be that, at least in face-to-face dealings, one who has reposed trust and confidence in another is entitled to assume the nonexistence of material facts that the other does not reveal.20 In the ordinary case, however, it is probably entirely fictional to say that a shareholder reposes trust and confidence in a director, officer, or controlling shareholder of a corporation. Indeed, the majority common law rule was that directors and other insiders owed a fiduciary duty to their corporation, but not to its shareholders, and that such insiders could trade in the corporation's securities without full disclosure.21 Only a minority of jurisdictions insisted that an insider owed a fiduciary duty to both his corporation and its shareholders, and required the insider to disclose all material facts in connection with his purchases of the company's securities.22 The Su-
The common law influenced, but did not control, developments under Rule 10b-5. In *In re Cady, Roberts & Co.*, the Securities and Exchange Commission cited state law precedents which had imposed a "special obligation" of disclosure on "corporate insiders [such as] officers, directors and controlling stockholders," and held that Rule 10b-5 had extended this special obligation to other "persons who are in a special relationship with a company and privy to its internal affairs." According to the SEC,

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

In *Chiarella* the Supreme Court spoke approvingly of *Cady, Roberts* and subsequent cases which established that "silence in connection with the purchase or sale of securities may operate as a

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23. Strong v. Repide, 213 U.S. 419 (1909). The defendant in *Strong* was a director, the majority shareholder, and the administrator general of a corporation which owned land in the Philippines. While the defendant was negotiating to sell the corporation's land to the Philippine government, he purchased the plaintiff's stock through an agent, who did not disclose the identity of his principal. The price which the defendant paid for the plaintiff's shares was approximately one-tenth of what they were worth after the land sale was completed. In holding that the plaintiff had stated a cause of action, the Supreme Court indicated that a director does not ordinarily owe a duty of full disclosure to a shareholder from whom he purchases stock, but said that "there are cases where, by reason of the special facts, such duty exists." *Id.* at 431. The Court found that the defendant's multiple roles in the corporation, his knowledge of the state of the negotiations with the government, and his efforts to conceal his identity were "special facts" which imposed a duty of disclosure on him. *Id.* at 432-33.

24. 40 S.E.C. 907 (1961). In *In re Cady, Roberts*, a partner of a brokerage firm learned from one of the firm's employees, who was also a director of Curtiss-Wright Corporation, that Curtiss-Wright planned to cut its dividend. Acting upon this nonpublic information, the partner sold the Curtiss-Wright stock owned by his customers. The Securities and Exchange Commission found that the partner and his firm had violated Rule 10b-5.

25. *Id.* at 912.

26. *Id.*

27. *Id.* (footnote omitted).

fraud actionable under § 10(b)." But, insisted the Court, "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Again in Dirks, the Court insisted that the duty to disclose is based on "a specific relationship between the shareholders and the individual trading on inside information." The Court's focus in Chiarella and Dirks was not, like the Commission's focus in Cady, Roberts, on the insider's actual relationship to his company, but on his constructive relationship to its shareholders.

The theory underlying Chiarella and Dirks is that an insider who buys or sells securities on the basis of material nonpublic information, or a tippee who buys or sells on the basis of such information with the knowledge that an insider has improperly disclosed it to him, "deceives" or "defrauds" the shareholders with whom he trades. If trading on nonpublic information violates Rule 10b-5 only when the trader or his tipper has a preexisting fiduciary duty to the other transacting party, so that the trader's failure to disclose material facts can be said to defraud that other party, many instances of trading on nonpublic information will fall outside the prohibitions of the rule. The Supreme Court appears willing to ease

30. Id.
31. 463 U.S. at 655.
32. For an excellent analysis and criticism of the Supreme Court's reasoning in Chiarella, see Anderson, Fraud, Fiduciaries, and Insider Trading, 10 HOFSTRA L. REV. 341 (1982).
33. The reasoning of Chiarella and Dirks does not bar an outsider from trading in securities on the basis of material nonpublic information obtained from a source independent of the issuer, since the outsider ordinarily does not owe any fiduciary duty to the security holders with whom he trades. Chiarella itself involved an outsider's trading on the basis of information obtained from third parties — potential takeover bidders — about their impending but unannounced offers for the securities of target companies. Because a great deal of trading on nonpublic information occurs in connection with tender offers, the SEC responded to the Chiarella decision by adopting Rule 14e-3, 17 C.F.R. § 240.14e-3 (1984), under § 14(e) of the Securities Exchange Act, 15 U.S.C. § 78n(e) (1982). Rule 14e-3 prescribes trading in a target company's securities by persons who possess material nonpublic information relating to a tender offer when they know the information was acquired directly or indirectly from the offeror, the target, or an insider of either.

Some commentators have expressed doubt that Rule 14e-3 is valid. See, e.g., Heller, Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" Versus Economic Theory, 37 BUS. LAW 517, 541-46 (1982); Phillips, Insider Trading Liability After Dirks, 16 REV. SEC. REG. 841, 847-48 (1983). Whether or not Rule 14e-3 is valid, it does not outlaw trading by those who possess nonpublic information concerning events other than tender offers. For example, neither Rule 14e-3 nor the Chiarella-Dirks reasoning would prohibit a judicial clerk from selling shares of a particular company on the basis of his knowledge that a huge judgment would soon be rendered against it, or prevent an executive from buying shares of a company to which his
the rigors of the \textit{Chiarella-Dirks} mode of analysis by adopting an expansive view of what constitutes a fiduciary relationship between trading parties.\textsuperscript{34} In order to develop a coherent scheme of liability, however, the Court should supplement or replace its current mode of analysis with the “misappropriation” theory.

\section*{II. Limitations of the \textit{Chiarella-Dirks} Analysis}
Under the Supreme Court’s reasoning, a person who trades on the basis of material nonpublic information violates Rule 10b-5 when he owes a fiduciary duty to the party with whom he trades.\textsuperscript{35} This reasoning seems most directly applicable to the case in which a traditional insider — a director, officer, or controlling stockholder — buys stock from one of the company’s shareholders. Although the authorities are hardly unanimous on the issue, there is substantial support for the proposition that a traditional insider owes a fiduciary duty to the corporation’s shareholders, including those from whom he purchases stock.\textsuperscript{36}

Both \textit{Chiarella} and \textit{Dirks} suggest that the Supreme Court takes a broad view of what constitutes a fiduciary relationship, and places ordinary corporate employees in the category of “insiders.” The opinions in both cases quote approvingly from the \textit{Cady, Roberts decision,}\textsuperscript{37} which indicated that Rule 10b-5 extended the duty to disclose inside information or abstain from trading to all persons who enjoy “a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose.”\textsuperscript{38} In \textit{Dirks} the Court assumed that the corporate employees who gave information to Dirks had a “\textit{Cady, Roberts} duty to the corporation’s shareholders,”\textsuperscript{39} and in \textit{Chiarella}\textsuperscript{40} the Court cited \textit{Brophy v. Cities Service Co.},\textsuperscript{41} which held that a corporate employee who bought stock on the basis of inside information violated a duty to the corporation.\textsuperscript{42} The Court’s apparent willingness to enlarge the category of persons deemed to owe a fiduciary duty to a company’s shareholders

\begin{itemize}
\item own corporation planned to award a profitable contract.
\item \textsuperscript{34} See infra notes 39-45 and accompanying text.
\item \textsuperscript{35} See supra text accompanying notes 28-30.
\item \textsuperscript{36} See, e.g., supra note 22.
\item \textsuperscript{37} See \textit{Dirks}, 463 U.S. at 653-54; \textit{Chiarella}, 445 U.S. at 226-27.
\item \textsuperscript{38} 40 S.E.C. at 912.
\item \textsuperscript{39} \textit{463 U.S.} at 666.
\item \textsuperscript{40} 45 U.S. at 228 n.10.
\item \textsuperscript{41} 31 Del. Ch. 241, 70 A.2d 5 (1949).
\item \textsuperscript{42} \textit{Id.}
\end{itemize}
tends to mitigate the impact of its holding that liability for insider trading is conditioned on a specific relationship between the trading parties. Still, the requirement of such a relationship creates a number of analytical problems.

A. Insider Sales

An insider who sells rather than buys stock deals not with existing shareholders, but with future shareholders of the corporation. Because directors and officers do not owe fiduciary duties to prospective shareholders, the common law did not impose a duty of disclosure upon an insider who sold securities on the basis of material inside information. In Chiarella the Supreme Court recognized the difficulty of bringing sales by insiders within its general theory of liability for insider trading, but appeared ready to accept Judge Hand’s argument that

the director or officer assume[s] 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.

The distinction between the insider who sells and the insider who buys may well be a “sorry” one, but it is a natural consequence of a theory which premises liability on a preexisting relationship between the trading parties.

B. Trading by Tippees

The Supreme Court has recognized that its approach to insider trading, with its emphasis on the requirement of a preexisting relationship between those who trade, does not easily justify a proscription of trading by tippees. In a footnote in Chiarella the Court observed that “[t]he tippee’s obligation has been viewed as arising from his role as a participant after the fact in the insider’s breach of a fiduciary duty.” Expanding upon the suggestion contained in that

43. See Cook & Feldman, Insider Trading Under the Securities Exchange Act, 66 Harv. L. Rev. 385, 409 (1953) (asserting that no case decided before 1934 found “a corporate official liable for a sale to a person not a stockholder, since in such a case it was . . . difficult to find a fiduciary relationship which had been abused”).
44. 445 U.S. 222 (1980).
45. Id. at 227 n.8 (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir.), cert. denied, 341 U.S. 920 (1951), quoted in In re Cady, Roberts & Co., 40 S.E.C. 907, 914 n.23 (1961)).
46. 445 U.S. at 230 n.12 (citing ABA Subcomm. on Corporation, Banking, and Business
footnote, the Court held in *Dirks* that a tippee "assumes a fiduciary
duty to the shareholders of a corporation" and is obliged to refrain
from trading on inside information "when the insider has breached
his fiduciary duty to the shareholders by disclosing the information
to the tippee and the tippee knows or should know that there has
been a breach." Precisely how a breach by the insider creates the
requisite fiduciary duty on the part of the tippee is unclear. What is
clear, as the Court acknowledged, is "[t]he need for a ban on some
tippee trading." Just as pragmatic considerations militate against
any distinction between an insider who buys and an insider who sells,
they call for the extension of liability to an outsider who aids an
insider in violating his trust.

The Court's theory of tippee liability — that an insider's breach
of a fiduciary duty subjects his tippee to a similar duty — does not
bar trading by all outsiders who come into the possession of inside
information. If an insider passes information to an outsider for a le-
gitimate corporate purpose, and thus does not breach his own fiduci-
ary duty to the corporation's shareholders, the outsider does not ac-
quire any derivative duty to refrain from trading. Apparently,
however, the Supreme Court perceives a need to prohibit outsiders
from trading on the basis of inside information that is disclosed to
them for a proper purpose and with the understanding that the inform-
ation will be kept confidential. In *Dirks* the Court noted that
"[u]nder certain circumstances, such as where corporate information
is revealed legitimately to an underwriter, accountant, lawyer, or
consultant working for the corporation, these outsiders may become
fiduciaries of the shareholders." Without softening its insistence on

Law, Comment Letter on Material, Non-Public Information (1973), reprinted in BNA, Se-
curities Regulation & Law Report No. 233, at D-1, D-2 (Jan. 2, 1974)).
48. *Id.* at 660 (footnote omitted).
49. *Id.* at 659. The Court explained that the ban is necessary to prevent insiders from
exploiting corporate information by trading through agents. *Id.* at 659-60.
50. *Id.* at 655 n.14. "The basis for recognizing this fiduciary duty," said the Court, "is
not simply that such persons acquired nonpublic corporate information, but rather that they
have entered into a special confidential relationship in the conduct of the business of the enter-
prise and are given access to information solely for corporate purposes." *Id.* (citations omit-
ted). The Court cautioned that "[f]or such a duty to be imposed . . . the corporation must
expect the outsider to keep the disclosed nonpublic information confidential, and the relation-
ship at least must imply such a duty." *Id.*

The meaning of footnote 14 in the *Dirks* opinion was at issue in SEC v. Lund, 570 F.
the defendant, the president of Verit Industries, whether Verit wished to participate in a joint
venture that P & F was planning with a third party. *Id.* at 1399-1400. The defendant then
the critical importance of a fiduciary duty to the shareholders, the Court simply added “temporary insiders” to the categories of persons deemed to be fiduciaries, in order to extend to them the obligation to refrain from trading on material inside information.

C. Trading in the Options Market

As the foregoing discussion indicates, *Chiarella* and *Dirks* support the imposition of a disclose-or-abstain obligation on traditional insiders, employees of the issuer, knowing tippees, and temporary insiders. The reasoning of the cases should bar insider trading in debt as well as equity securities, since it is arguable that the holders of debt securities are among the classes of persons to whom insiders owe fiduciary duties.\(^5\) *Chiarella* and *Dirks* suggest, however, that Rule 10b-5 might not proscribe trading in the options market on the basis of material nonpublic information.

A corporate insider who buys or sells options on his corporation’s securities does not necessarily have any relationship to the options traders with whom he deals. As a consequence, the Supreme Court’s reasoning would not appear to bar him from trading in options on the basis of material inside information.\(^6\) Congress, recog-

\(5\) See Pepper v. Litton, 308 U.S. 295 (1939), in which the Supreme Court indicated that a majority shareholder owes fiduciary duties to “the corporation, its stockholders and creditors.” *Id.* at 311 (emphasis added). See also Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 Calif. L. Rev. 1, 40 (1982) (concluding that an insider’s fiduciary obligations to a debtholder “may be sufficient to create an abstain-or-disclose rule”).

\(6\) The first post-*Chiarella* case to examine the duties of insiders to options traders was O’Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981). In *O’Connor* the plaintiff charged that the insiders of either a takeover bidder or the target company had tipped nonpublic information to persons who then purchased call options on the target’s stock. Although the court held that the plaintiff, an options seller, had stated a cause of action under Rule 10b-5, it based its holding on the misappropriation theory of liability. *Id.* at 1185. The court conceded that the insiders and their tippees had not violated any fiduciary duty to the plaintiff:

The relationship between corporate insiders and shareholders stands in stark contrast to the lack of relationship between the corporate insiders and options traders.
nizing the difficulty, responded to *Chiarella* and *Dirks* by amending Section 20(d) to the Securities Exchange Act of 1934.\(^8\) Section 20(d) now establishes that Rule 10b-5 prohibits a person who possesses material nonpublic information from trading in options whenever the rule prohibits him from trading in the underlying securities.\(^{64}\)

Even before Section 20(d) became law, a federal district court concluded that a group of defendants may have violated Rule 10b-5 by trading in options on the basis of material nonpublic information.\(^{65}\) The court, however, did not rely on the mode of analysis that the Supreme Court had adopted in *Chiarella*. Instead, it turned to the "misappropriation" theory of liability.\(^{66}\)

### III. THE MISAPPROPRIATION THEORY

The *Chiarella-Dirks* reasoning reaches cases of true "insider" trading — trading by an insider of the issuer, or guilty tippee of an insider, in the issuer's own securities. This reasoning, however, does

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While it is true that shareholders and options traders both rely on the fortunes of corporations, the dispositive distinction is that the options trader has no equity interest in the corporation by virtue of his selling or purchasing an option on the corporation's stock. . . . \(\ldots\) While the option writer may obligate himself in the future to purchase shares of the corporation (in the event a "naked option" is exercised), this purchase is solely for the purpose of turning the shares over to the other contractual party, not for the purpose of investing in the fortunes of the corporation. Whatever relationship this may create with the corporation, it cannot be said that it rises to the level of a relationship of trust and confidence between the options trader and the corporate insider.

*Id.* at 1184-85.


54. Section 20(d) reads as follows:

Wherever communicating, or purchasing or selling a security while in possession of material, nonpublic information would violate, or result in liability to any purchaser or seller of the security under any provision of this chapter, or any rule or regulation thereunder, such conduct in connection with a purchase or sale of a put, call, straddle, option, or privilege with respect to such security or with respect to a group or index of securities including such security, shall also violate and result in comparable liability to any purchaser or seller of that security under such provision, rule, or regulation.

*Id.*

55. *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1186-87 (S.D.N.Y. 1981) (holding that the plaintiff had stated a cause of action against tippees who allegedly purchased call options on the basis of nonpublic information passed to them by insid-


56. 529 F. Supp. at 1184-88.
not reach cases of "outsider" trading — trading by a person who is not an insider of the issuer and has not improperly received information from an insider. Yet a great deal of trading on nonpublic information, particularly in connection with tender offers, is trading by outsiders who did not obtain their information, directly or indirectly, from the issuers of the securities they trade. If an outsider who trades on nonpublic outside information is to be called to account under Rule 10b-5, it is necessary to identify some "fraud" that the outsider has committed. The Securities and Exchange Commission has been arguing, with considerable success, that the requisite fraud occurs when the outsider "misappropriates" information entrusted to him by his employer or another person, and he or his tippee trades on the basis of that information.

A. The Origins of the Theory

In its brief to the Supreme Court in Chiarella, the United States argued that the defendant had "committed fraud against both the acquiring corporations whose information he converted and the investors who sold him securities in ignorance of forthcoming market events of critical importance." The government insisted that Chiarella's "secret conversion of confidential information operated as a fraud on the corporations that entrusted him with that information," and also that his "purchase of securities based on material non-public information obtained by misappropriation constituted fraud on the sellers of those securities." Each of these arguments — that the act of misappropriation is a fraud on the rightful possessor of the misappropriated information, and that trading on misappropriated information is a fraud on the parties with whom the misappropriator trades — was discussed in the Chiarella opinions.

57. Freeman contends that outsider trading has become a significant problem because of "the proliferation of tender offers by outsiders and the creation of an option market in which the traders are not insiders." Freeman, supra note 50, at 228.
60. Id. at 28.
61. Id. at 38-39.
Justice Powell, writing for the majority in Chiarella, acknowledged the government’s argument that the defendant had breached a duty to the acquiring corporations that had entrusted information to his employer. The majority found, however, that the jury that had convicted Chiarella had not been “instructed on the nature or elements of a duty . . . to anyone other than the sellers.” As a consequence, the Court refused to “speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b).”

Justice Stevens, who provided the critical fifth vote for the majority opinion, wrote separately to stress that the Court had not decided whether Chiarella’s “breach of his duty of silence — a duty he unquestionably owed to his employer and to his employer’s customers — could give rise to criminal liability under Rule 10b-5.” Justice Brennan, concurring in the judgment on the ground that the jury instructions had been inadequate, insisted that “a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities.” Chief Justice Burger, dissenting, read Section 10(b) and Rule 10b-5 “to mean that a person who has misappropriated nonpublic information has an absolute duty to

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63. Id. at 236. The majority explicitly disagreed with Chief Justice Burger’s contention that the jury had been “properly instructed on the theory ‘that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.’” Id. at 237 n.21 (citation omitted). Further, the majority indicated that it would have reversed Chiarella’s conviction even if the jury had been instructed that it could find him guilty either because he had failed to disclose material information to the selling shareholder or because he had breached a duty to a third party. The Court could not uphold a conviction that might have been based on noncriminal conduct. Id.
64. Id. at 236-37 (footnote omitted).
65. Id. at 238 (Stevens, J., concurring). Justice Stevens outlined the opposing views: On the one hand, if we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted “a fraud or a deceit” upon those companies “in connection with the purchase or sale of any security.” On the other hand, inasmuch as those companies would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, . . . it could also be argued that no actionable violation of Rule 10b-5 had occurred.
66. Id. at 239 (Brennan, J., concurring). Justice Brennan specifically rejected the majority’s suggestion “that no violation of § 10(b) could be made out absent a breach of some duty arising out of a fiduciary relationship between buyer and seller.” Id.
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disclose that information or to refrain from trading.67

Thus, while four members of the Chiarella majority declined to consider the validity of the misappropriation theory, Justice Stevens indicated that there was a “legitimate argument” that Chiarella had defrauded the companies that had entrusted his employer with the information that he converted to his own use.68 Chief Justice Burger and Justice Brennan contended that Chiarella’s misappropriation of nonpublic information subjected him to an absolute duty to disclose that information or refrain from trading,69 so that his trading without disclosure constituted a fraud on the other parties to his transactions, or on the entire marketplace. Finally, Justices Blackmun and Marshall, dissenting, argued that “persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.”70 Their expansive view made it easy for them to find, without any reliance on the misappropriation theory, that Chiarella had violated Rule 10b-5.71

B. The Merits of the Theory

The misappropriation theory, in its most general form, is the theory that a person who buys or sells securities on the basis of material nonpublic information that he has misappropriated from another person is guilty of a violation of Rule 10b-5. This broad statement of the theory, however, is too imprecise to be evaluated meaningfully, since it evades the critical question of what constitutes the prohibited fraud.

Chief Justice Burger’s dissenting opinion in Chiarella rests on the premise that it is the defendant’s failure to disclose the misappropriated information to those with whom he trades that constitutes the fraud.72 The Chief Justice conceded that, in the absence of a

67. Id. at 240 (Burger, C.J., dissenting).
68. Id. at 238 (Stevens, J., concurring).
69. Id. at 240 (Burger, C.J., dissenting); id. at 239 (Brennan, J., concurring).
70. Id. at 251 (Blackmun, J., dissenting). Justice Blackmun voiced strong objections to the Court’s continuing effort to restrict the scope of § 10(b) and Rule 10b-5. He charged that the Court had failed “even to attempt a justification of its ruling in terms of the purposes of the securities laws, or to square that ruling with the longstanding but now much abused principle that the federal securities laws are to be construed flexibly rather than with narrow technicality.” Id. at 246-47 (citations omitted).
71. Id.” at 252 (Blackmun, J., dissenting).
72. Id. at 240.
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fidiucial relationship between the parties, one party to a business transaction ordinarily has no obligation to disclose information to the other. Nevertheless, he urged, "the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means." Thus, according to the Chief Justice, "an absolute duty to disclose or refrain arises from the very act of misappropriating nonpublic information."

The lower courts have not embraced Chief Justice Burger's version of the misappropriation theory, perhaps in part because it is unconvincing. There is virtually no authority for the view that a defendant who has unlawfully obtained information, or improperly converted information to his own use, is subject to an absolute duty to disclose it to those with whom he transacts business. The only authority that the Chief Justice cited in support of his theory argued that "there should be a duty," not that there is a duty, to disclose information that was acquired illegally. The Chief Justice was cor-

73. Id. at 239-40 (Burger, C.J., dissenting) (citing W. PROSSER, LAW OF TORTS § 106 (2d ed. 1955)). This rule, Chief Justice Burger declared, "permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting." Id. at 240.
74. Id. at 240.
75. Id. at 243 n.4. The Chief Justice contended that the majority's "limited" holding — that mere possession of material nonpublic information is insufficient to create a duty to disclose or to refrain from trading — was not inconsistent with his view. Id.
76. The Second Circuit has expressly rejected the Chief Justice's version of the misappropriation theory. In United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 104 S. Ct. 193 (1981), the court held that a defendant had violated Rule 10b-5 by purchasing stock of a target company on the basis of information that a coconspirator had misappropriated and then passed to him. Nevertheless, in Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), cert. denied, 104 S. Ct. 1280 (1984), which involved the same facts as Newman, the court refused to allow an investor who had sold stock of the target company to bring a private action against the defendant under Rule 10b-5. After concluding that the defendant did not owe a duty of disclosure to the target shareholders, 719 F.2d at 13, the Moss court rejected the plaintiff's alternative argument "that any person who 'misappropriates' information owes a general duty of disclosure to the entire marketplace." Id. at 16. The court recognized that the plaintiff was relying on the version of the misappropriation theory that Chief Justice Burger and Justice Brennan had endorsed in Chiarella, but declined to adopt their view on the ground that it contradicted the holdings in Chiarella and Dirks. Id.
77. 445 U.S. at 240 (Burger, C.J., dissenting). Chief Justice Burger quoted the following passage:

[T]he way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part. . . . Any time information is acquired by an illegal act it would seem that there should be a duty
rect in suggesting that a rule requiring disclosure of misappropriated information would not penalize those who had developed information through "superior experience, foresight, or industry." Still, the lack of a persuasive argument against the creation of a disclosure obligation does not compel the recognition of such an obligation. As the Chief Justice conceded, the general rule is that one party to a business transaction has no duty of affirmative disclosure to the other. An exception to the general rule is justified when one of the parties is a fiduciary, since the fiduciary's failure to disclose material facts to a person who is entitled to rely on him is a tacit representation of the nonexistence of those facts. There is no obvious reason, however, why one who has misappropriated information ought to be deemed to be making any particular representation to those with whom he deals.

The Chief Justice's version of the misappropriation theory also appears to be inconsistent with the language and reasoning of Chiarella and Dirks. In Chiarella, Justice Powell emphasized that liability for fraudulent nondisclosure "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." Justice Stevens, who thought that the Court had actually determined that Chiarella "owed no duty of disclosure to the sellers," apparently believed that the majority had held that a fiduciary or similar relationship is the exclusive source of such a duty. Again in Dirks, the Court insisted that a duty of disclosure "arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market." The Supreme Court, as the Second Circuit has concluded, appears already to have rejected Chief Justice Bur-

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78. Id. at 240 (Burger, C.J., dissenting).
79. Id. at 239-40 (citing W. PROSSER, LAW OF TORTS § 106 (2d ed. 1955)). See also 1 F. HARPER & F. JAMES, JR., THE LAW OF TORTS § 7.14, at 586 (1956).
80. "[S]ituations and relations may be of such a character that the law will impose a duty upon one to speak, in which case silence will amount to a misrepresentation." 1 F. HARPER & F. JAMES, JR., THE LAW OF TORTS § 7.14, at 588 (1956). See also RESTATEMENT (SECOND) OF TORTS § 551 (1977).
81. 445 U.S. at 230.
82. Id. at 237 (Stevens, J., concurring) (emphasis added).
83. Id. at 238.
84. 463 U.S. at 658 (quoting Chiarella, 445 U.S. at 231-32 n.14).
85. See supra note 76.
ger’s view that anyone who has misappropriated nonpublic information is under an absolute duty to disclose it or refrain from trading.

Rejection of the Chief Justice’s version of the misappropriation theory does not necessarily imply that an outsider who misappropriates confidential information is free to use it in his trading. Even though the misappropriator does not owe a duty of disclosure to those with whom he trades or to the entire marketplace, his trading on the basis of misappropriated information may nevertheless violate Rule 10b-5. In United States v. Newman,86 the Second Circuit indicated that a person who misappropriates nonpublic information commits a fraud on the rightful possessor of the information, and that his subsequent trading on the misappropriated information connects his fraud with a purchase or sale of securities.87 In Newman, two employees of investment banking firms conveyed confidential information about proposed mergers and acquisitions to their coconspirators, who bought stock in the target companies and then sold the stock at a gain when the takeovers were announced.88 The district court dismissed an indictment charging one of the coconspirators with violating Rule 10b-5, but the Second Circuit reversed.89 The Second Circuit held that the members of the conspiracy had defrauded the investment banking firms by “sullying” their reputations, and had “wronged” the acquiring companies — the firms’ clients — by making purchases that drove up the prices of the targets’ securities.90 The court held, further, that the “fraud” that had been perpetrated on the investment banking firms and their clients had occurred “in connection with” the conspirators’ purchases of stock in the target companies.91

Despite the novelty of the misappropriation theory, the Newman court concluded that it needed to “spend little time on the issue of fraud and deceit.”92 The court merely observed that the wrongdoing charged in the indictment was “not simply internal corporate mismanagement,”93 that the employees of the investment banking firms and their coconspirators had caused damage to the firms and their

87. Id. at 17-18.
88. Id. at 15.
89. Id. at 14.
90. Id. at 17.
91. Id. at 18.
92. Id. at 17.
93. Id. (citing Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6 (1971)).
clients, and that the deceitful misappropriation of confidential information by a fiduciary is generally held to be unlawful. The court also gave short shrift to the argument that the alleged fraud had no connection with the purchase or sale of securities. Because the employees of the investment banking firms had misappropriated information for the sole purpose of guiding the purchase of stock by their coconspirators, the court found "little merit" in the "disavowal of a connection between the fraud and the purchase." It was sufficient that the alleged fraud "touched" the sale of securities, and irrelevant that its victims were not purchasers or sellers.

Although the Newman court reached the correct result, it did not adequately explain why one who misappropriates confidential information and trades on it, or conveys it to another who trades on it, is guilty of fraud. The court's arguments establish only that the misappropriation of information by one who has been granted custody of it is wrongful. What makes the misappropriator's conduct not only wrongful, but fraudulent, is his deception of the person who entrusted the information to him.

In Superintendent of Insurance v. Bankers Life & Casualty Co., the Supreme Court characterized a sole shareholder's misappropriation of the proceeds from his corporation's sale of bonds as a "'garden variety' type of fraud." The commentary in a leading casebook criticizes Superintendent of Insurance as indicating that "just plain stealing" is fraud, but the decision does not actually go so far. As the Court subsequently explained, the case "involved deceptive conduct as part of the Rule 10b-5 violation alleged," because the corporation was "duped" into believing that it would receive the

94. Id.
95. Id. at 18.
96. Id. (citation omitted).
97. Id.
98. Id. at 17. Rule 10b-5, the court noted, "contains no specific requirement that fraud be perpetrated upon the seller or buyer of securities." Id. The courts themselves authorized private actions for damages under Rule 10b-5, and decided that only purchasers and sellers could bring such actions. Id. When the government institutes litigation under Rule 10b-5, however, "the court's concern must be with the scope of the Rule, not plaintiff's standing to sue." Id.
99. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471-74 (1977) (holding that Rule 10b-5 does not provide a remedy for breach of fiduciary duty without manipulation, deception, or nondisclosure).
100. 404 U.S. 6 (1971).
101. Id. at 11 n.7.
proceeds from the sale of its bonds.\textsuperscript{103} Similarly, an agent or employee who is given custody of nonpublic information, with the understanding that he will keep the information confidential and refrain from using it for personal profit, “duplicates” those who entrusted the information to him when he conveys it to others or trades on the basis of it.\textsuperscript{104}

In short, the misappropriation of confidential information by one to whom it was entrusted is fraudulent conduct, just as the embezzlement of money by one to whom it was entrusted is fraudulent conduct.\textsuperscript{105} In both instances the party who gave the wrongdoer the custody of a thing of value has been deceived by the latter’s implicit representation that he would not convert the thing to his own use. That the victim of an embezzlement is deprived of his money or other property, while the person from whom information is misappropriated continues to possess the information, should not obscure the basic point. The embezzler or misappropriator is guilty of deceiving the party who reposed trust and confidence in him.

Although one who misappropriates confidential information deceives the person who entrusted the information to him, the ultimate damage may be suffered by others. The \textit{Newman} court seemed to assume that it needed to identify some damage to the parties that

\textsuperscript{103} Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 475 n.15 (1977) (quoting Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 9 (1971)).

\textsuperscript{104} In United States v. Newman, for example, the employees of the investment banking firms “deceived” or “doped” their employers, as well as their employers’ clients, by passing confidential information to their confederates. 664 F.2d at 17. \textit{See also} United States v. Proctor & Gamble Co., 47 F. Supp. 676 (D. Mass. 1942), in which the defendant was charged with mail fraud for paying bribes to employees of a competitor in exchange for trade secrets. The court, in finding that the indictment sufficiently alleged a “scheme to defraud,” reasoned as follows:

The normal relationship of employer and employee implies that the employee will be loyal and honest in all his actions with or on behalf of his employer, and that he will not wrongfully divulge to others the confidential information, trade secrets, etc., belonging to his employer. . . . When one tampers with that relationship for the purpose of causing the employee to breach his duty he in effect is defrauding the employer of a lawful right. The actual deception that is practiced is in the continued representation of the employee to the employer that he is honest and loyal to the employer’s interests. The employee, in using the employment relationship for the express purpose of carrying out a scheme to obtain his employer’s confidential information and other property . . . would be guilty of deliberately producing a false impression on his employer in order to cheat him. Such conduct would constitute a positive fraud. . . .

\textit{Id.} at 678 (citations omitted).

\textsuperscript{105} “[I]t is impossible for a person to embezzle the money of another without committing a fraud upon him.” Grin v. Shine, 187 U.S. 181, 189 (1902).
were deceived — the investment bankers and the acquiring companies that were their clients — in order to establish the elements of a fraud.\footnote{106} But whether or not those parties suffered economic harm, the deceit that was practiced on them resulted in financial injury to members of the investing public.\footnote{107} The concept that a fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons, is not unknown in our law. For example, one who makes misrepresentations to a testator in order to induce him to eliminate a bequest to his favorite nephew deceives the testator, but causes a financial injury to the nephew.\footnote{108} Similarly, one who misappropriates confidential information and uses it in his securities trading deceives the rightful owner or possessor of the information, but causes economic harm to other investors.

The fraud perpetrated by one who misappropriates confidential information is not complete until someone is damaged.\footnote{109} The damage occurs, and Rule 10b-5 is violated, when the misappropriator or his tippee uses the information “in connection with the purchase or sale of any security.”\footnote{110} The \textit{Newman} court introduced an unnecessary complication when it argued that the federal securities acts have a broader purpose than the protection of investors.\footnote{111} In fact,
the employees who passed confidential information to their coconspirators deceived the investment banking firms that employed them and the acquiring companies that were the firms' clients, but the coconspirators' trading caused damage to certain investors who sold, or failed to purchase, securities of the target companies. The entire scheme, embracing the misappropriation of confidential information and the use of that information in trading, was a fraud. The victims of the fraud were investors.

C. The Implications of the Theory

The theory that one who misappropriates confidential information deceives the person who entrusted the information to him, and that his trading on the information causes damage to other investors, provides a generalized explanation of why trading on nonpublic information in an impersonal market may violate Rule 10b-5. Instead of defining fraud as one trading party's failure to disclose nonpublic information to another, the theory finds fraud in the trading party's deceitful exploitation of information rightfully belonging to a third person. Trading on nonpublic information is not fraudulent simply because a particular trader has an informational advantage; such trading is fraudulent when the trader has an informational advantage which he secured through an abuse of position, a violation of trust, or a betrayal of confidence.

One of the virtues of the misappropriation theory is that it eliminates many of the fictions and anomalies that are associated with the Chiarella-Dirks reasoning. Because the theory focuses on the misappropriator's actual obligation to the person who entrusted information to him, instead of on his fictional relationship to the parties with whom he trades, it proscribes the conduct of outsiders as well as insiders who take unfair advantage of privileged access to confidential information. It eliminates any distinction between insiders who buy and insiders who sell securities. It reaches the tipper who misappropriates information, and the tippee who subsequently trades upon it, as coparticipants in a fraud. And it covers the activities of those who trade in options, or in debt securities, as well as those who trade in stock.

The misappropriation theory does not outlaw all trading on the basis of nonpublic information. When one who has been entrusted

112. See supra note 107.
113. See supra notes 35-52 and accompanying text.
with nonpublic information trades on it with the permission of the person or persons who entrusted it to him, the misappropriation theory is inapplicable.\textsuperscript{114} When one fortuitously discovers information that is not known to the public, the theory does not prevent him from using that information in his trading.\textsuperscript{115} When one simply steals information from a stranger, his trading on the information does not involve deception or fraud, and therefore should not be held to violate Rule 10b-5.\textsuperscript{116} Properly understood, the misappropriation theory only bars trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information.\textsuperscript{117}

The misappropriation theory, so understood, comports well with our intuition about what is wrong with trading on nonpublic information. Most of us would not perceive such trading to be unfair merely because one trading party knows more than another. We would probably agree that anyone is entitled to exploit any information that he has developed through special insight or diligent effort.\textsuperscript{118} Nor do we begrudge another the benefit of knowledge that he

\textsuperscript{114} In \textit{Chiarella}, Justice Blackmun criticized the misappropriation theory as unduly narrow; he would have found a violation of Rule 10b-5 "even if [Chiarella] had obtained the blessing of his employer's principals before embarking on his profiteering scheme," 445 U.S. at 246 (Blackmun, J., dissenting). It seems unlikely, however, that many employers would permit their employees to trade on nonpublic information. \textit{See Ross, Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory in Issues in Financial Regulation} 177, 184 (F. Edwards ed. 1979) (arguing that shareholders have an interest in prohibiting managers from trading on inside information in order to avoid overcompensating them).

\textsuperscript{115} A person might, for example, accidentally overhear an insider's discussion of nonpublic information. \textit{See SEC v. Switzer, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH)} ¶ 91,589 (W.D. Okla. June 29, 1984) (holding that Rule 10b-5 does not bar trading on the basis of information inadvertently revealed by an insider). One is tempted to refer to the lucky listener as a "serendipitippee."

\textsuperscript{116} Chief Justice Burger would, of course, read Rule 10b-5 to bar burglars and thieves from trading on stolen information. \textit{See Chiarella}, 445 U.S. at 241-42 (Burger, C.J., dissenting) (indicating that a disclose-or-abstain obligation should arise "whenever a party gains an informational advantage by unlawful means").

\textsuperscript{117} Because of the fiduciary or similar relationship between the parties, the conversion is a deceitful or fraudulent act. \textit{See Langevoort, Fraud and Deception by Securities Professionals}, 61 Tex. L. Rev. 1247, 1264 (1983) (asserting that in prosecutions for mail fraud, "the courts have by and large accepted the notion that secretive fiduciary misconduct, at least to the extent that it 'corruptly' benefits the defendant, is the equivalent of an active fraud").

\textsuperscript{118} Professor Brudney has argued that the unfairness of insider trading "is not a function merely of possessing more information — outsiders may possess more information than other outsiders by reason of their diligence or zeal — but of the fact that [the insider has] an advantage which cannot be competed away." Brudney, \textit{Insiders, Outsiders, and Informational
has accidentally acquired;\textsuperscript{119} after all, we ourselves might enjoy some good fortune one of these days.\textsuperscript{120} On the other hand, no one likes to play a game with an opponent who has loaded the dice. We think that those who have special access to information, because of employment or other relationships, should be barred from using that information to gain an advantage over the rest of us.\textsuperscript{121} We do not believe that a person with privileged access to information has a duty to tell us everything he knows; on the contrary, we recognize that he should honor his obligation to keep confidential information to himself. We do believe, however, that he should refrain from taking advantage of his position of trust to our detriment, or to the detriment of others who are playing by the rules.\textsuperscript{122}

To conclude that a person who misappropriates and trades on nonpublic information violates Rule 10b-5 does not resolve whether he could be held liable in a private action for damages. The version of the misappropriation theory endorsed in this Article posits that one who misappropriates and trades on nonpublic information deceives the owner or rightful possessor of the information, but damages or defrauds other investors. When the unlawful trading has taken place in an impersonal market, it will generally be impossible to ascertain the identities of the injured investors.\textsuperscript{123} Even if some injured parties can be identified, they may not have purchased or

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\textsuperscript{119}. One witness at a recent Congressional hearing cited the classic example of a motorist who is driving on a deserted road when he observes a huge explosion in the XYZ plant. The motorist, who owns XYZ stock, immediately calls his broker and instructs him to sell the stock. The witness concluded that the average investor would not expect the motorist to refrain from selling. The Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Sec. of the Senate Comm. on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess.115, 119 (1984) (statement of Faith Colish, Esq., Chairman of the Comm. on Sec. and Exchs., New York County Lawyers Ass'n).

\textsuperscript{120}. Americans regard luck as "profoundly democratic," because its benefits may fall upon anyone. D. Yankelovich, New Rules 142 (1981).

\textsuperscript{121}. Several commentators have concluded that the principal objection to insider trading is that the insider is making unfair use of a privileged position. See, e.g., Anderson, supra note 32, at 353-54; Brudney, supra note 118, at 343-49.

\textsuperscript{122}. "[T]he average American... probably has a visceral reaction that inside trading definitely harms someone else in the market and may harm the issuer. This reaction is absolutely correct." Wang, supra note 107, at 1248.

\textsuperscript{123}. As Professor Wang has explained, "it is impossible to recreate the hypothetical universe that would have existed" had there been no unlawful trading. The trading "directly or indirectly changes the inventory of a specialist or market-maker. There is no way of knowing how this change alters the intermediary's price quotations, and how these quotations affect the behavior of public investors." Wang, supra note 107, at 1312. As a consequence, the victims of the unlawful trading cannot be identified. Id.
sold any securities, and therefore will have no standing to sue.\textsuperscript{124} In view of the overwhelming theoretical and practical problems involved in identifying and compensating those who are injured by unlawful trading in an impersonal market, such trading ought not to give rise to any private right of action.\textsuperscript{125} On the other hand, the Securities and Exchange Commission and the Department of Justice should continue to seek sanctions against those who violate Rule 10b-5. The available sanctions — injuctions,\textsuperscript{126} disgorgement orders,\textsuperscript{127} civil fines,\textsuperscript{128} and criminal penalties\textsuperscript{129} — are well-suited to the goal of deterring trading on misappropriated information, and punishing those who engage in it.

**CONCLUSION**

In *Chiarella* and *Dirks* the Supreme Court established that Rule 10b-5 outlaws trading on nonpublic information only when such trading involves deception or fraud. This Article has argued that a person commits the requisite fraud when he misappropriates nonpublic information and uses it in purchasing or selling securities. The misappropriator’s conduct deceives the owner or rightful possessor of the information, causes damage to other investors, and violates Rule 10b-5.

The misappropriation theory provides a logical and coherent framework for the continuing development of the law regarding trading on nonpublic information. Instead of conditioning liability on the existence of a fiduciary relationship between trading parties, the theory premises liability on a party’s deception of those who have given him privileged access to confidential information. The Court’s adoption of the misappropriation theory would produce results consistent with our notions of fairness, and would avoid many of the difficulties inherent in the reasoning of *Chiarella* and *Dirks*. Most

\textsuperscript{124} A trade on misappropriated information could harm “induced traders”— those who would not have made unfavorable purchases or sales but for the trade on misappropriated information, or “preempted traders”— those who would have made favorable purchases or sales but for the trade on misappropriated information. See Wang, *supra* note 107, at 1235-36. Preempted traders would have no standing to sue under Rule 10b-5. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

\textsuperscript{125} Cf. Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627 (concluding that the corporation whose securities have been illegally traded should be the only party authorized to bring a private action).


importantly, because the theory justifies the imposition of sanctions on persons who engage in dishonest practices in order to secure an advantage in their securities trading, its adoption would tend to bolster public confidence in the integrity of the securities markets — and the legal system that polices them.