

The Misappropriation Theory of Insider Trading: Its Past, Present, and Future

*Troy Cichos**

I. INTRODUCTION

It happens all the time, without a second thought. People on the golf course, at the weekly card game, or at a backyard barbecue, pass on hot stock tips to friends and relatives. If asked about the possibility of violating insider trading laws, the following responses would be typical: "It could never happen to me," and "it's only a problem for large, powerful investors." These responses, while typical, are wrong. Just ask Carl Reiter.

One day on the golf course, one of Reiter's oldest friends advised him to buy stock in Revco Drug Stores; the friend knew "the guy doing the deal."¹ Reiter, a real estate developer, invested a few thousand dollars in the stock, made a profit of \$2,625 in two months, and thought the investment was over. It was not. Two years later, one of Reiter's golfing partners got a phone call from a person claiming to be an investigator for the Securities and Exchange Commission (SEC). The friend's response was "yeah, right, and I'm Ivan Boesky." The person *was* an investigator, and Reiter and the other golfers who acted on the stock tip were charged with violating insider trading laws.² Reiter eventually disgorged his profits resulting from the tip and paid a fine of the same amount.³ Reiter was shocked that the powerful SEC was concerned about his small investment and that insider trading laws applied to such conduct.⁴ The actions of the SEC in this case, however, are not unusual. The scope and application of

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1. Thomas E. Ricks, *How 4 Pals Who Mixed Golf and Stock Tips Landed in the Rough*, WALL ST. J., July 21, 1989, at A1.

2. *Id.*

3. *Id.*

4. *Id.* at A6.

insider trading have expanded the concept to a point that it is no longer limited to actual insiders and can affect any person who trades in securities.⁵

"Insider trading" is neither defined nor expressly prohibited by federal securities laws.⁶ Rather, the Securities and Exchange Act of 1934 (Act) broadly proscribes "deceptive" practices in connection with the purchase or sale of securities.⁷ Section 10(b) of the Act gives the SEC authority to promulgate rules and regulations to achieve those aims.⁸ Pursuant to this authority, the SEC adopted Rule 10b-5, which prohibits fraudulent and deceptive practices in the trading of securities.⁹ These two legislative and administrative enactments are the vehicles through which insider trading is prohibited and enforced.¹⁰

Because the prohibition against deceptive practices is broad, and because insider trading has not been specifically defined by Congress, the SEC and the judiciary have defined insider trading.¹¹ Unfortunately, this process has led to conflicting views of insider trading and to decisions based primarily on the facts of each case, rather than upon a bright line rule.¹² Moreover, the courts and the SEC do not always

5. See Barbara B. Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 OHIO ST. L.J. 373 (1988).

6. Audrey Strauss & Lisa Fishbone, *Insider Trading After Chestman*, 793 PLI/CORP. 365, *2 (1992), available in WESTLAW, Pli-Corp Library (pinpoint page numbers refer to WESTLAW pagination).

7. 15 U.S.C. § 78j(b) (1988); see also Strauss & Fishbone, *supra* note 6, at *1. Section 10(b) prohibits the use in "connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . ." 15 U.S.C. § 78j(b).

8. 15 U.S.C. § 78j(b) (1988); see Strauss & Fishbone, *supra* note 6, at *1.

9. 17 C.F.R. § 240.10b-5 (1994). This Section states:

It shall be unlawful for any person, directly or indirectly, by 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.

Id.

10. See *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); Strauss & Fishbone, *supra* note 6, at *1.

11. Strauss & Fishbone, *supra* note 6, at *1.

12. See Thomas L. Hazen, *United States v. Chestman - Trading Securities on the Basis of Nonpublic Information in Advance of a Tender Offer*, 57 BROOK. L. REV. 595, 597 (1991); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1990).

agree as to how wide the insider trading net should be cast.¹³ Three conclusions are certain. First, the vast majority of law in this area is created and advanced by courts within the Second Circuit.¹⁴ Second, the SEC and the Second Circuit courts generally attempt to interpret insider trading law as broadly as possible, leaving it to higher courts to scale back the law if interpreted too broadly.¹⁵ Third, insider trading can be divided into the following two categories: classic insider trading and the misappropriation theory of insider trading.¹⁶ These two categories extend the prohibitions of Section 10(b) to two different groups of individuals.

Classic insider trading is premised on the duty that a corporate employee owes to shareholders of the corporation: to place the shareholders' interests ahead of the employee's personal interests.¹⁷ The misappropriation theory, however, is premised upon the presence of *any* fiduciary or fiduciary-type relationship between two people or entities. Under the misappropriation theory, a party with no ties to a corporation or any of its employees may still violate insider trading laws by trading in the corporation's securities.¹⁸

Section 10(b) was first used to regulate insider trading in the early 1960's. The type of conduct regulated was closely tied to the express provisions of Rule 10b-5 that prohibit fraudulent and deceptive practices.¹⁹ However, in 1978 the Second Circuit used a much broader interpretation of Section 10(b) and Rule 10b-5 to combat insider trading in *Chiarella v. United States*.²⁰ Although the Supreme Court reversed the Second Circuit's broad interpretation in *Chiarella*,²¹ three years later the Court accepted an almost equally broad interpretation in *Dirks v. SEC*.²² These two cases represent the core of classic insider trading regulation.

13. Salbu, *supra* note 12, at 232; *see, e.g.*, *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

14. The Second Circuit encompasses the nation's largest financial market, New York, within its boundaries.

15. *See Chiarella*, 445 U.S. 222 (holding by Supreme Court that the Second Circuit had adopted an insider trading rule that strayed too far from the tenets of Rule 10b-5); Lisa J. Finnell, Comment, *United States v. Carpenter: Second Circuit Overextends the Misappropriation Theory of Criminal Liability Under Rule 10b-5*, 12 DEL. J. CORP. L. 605, 606 (1987).

16. *See Strauss & Fishbone, supra* note 6, at *1-2.

17. *See infra* Section II.

18. *See infra* Section III.

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

20. 588 F.2d 1358 (1978).

21. 445 U.S. 222 (1980).

22. 463 U.S. 646 (1983).

While the Supreme Court's reversal of *Chiarella* reduced the scope of Section 10(b) and Rule 10b-5, Chief Justice Burger's dissenting opinion in the case represents the germination of the misappropriation theory. In *United States v. Carpenter*,²³ the Second Circuit relied on Chief Justice Burger's discussion of misappropriation theory to advocate a very broad and wide reaching interpretation of Section 10(b) and Rule 10b-5—one that affects *any* person who makes a trade in *any* securities market.²⁴ This interpretation brings people who have no association with a corporate insider within the sphere of liability for insider trading and epitomizes the misappropriation theory of insider trading.²⁵ Although the Supreme Court has never explicitly affirmed the misappropriation theory,²⁶ the Court has expanded the scope of insider trading to such an extent that the activities being restrained are not those that Congress originally intended to restrain under Section 10(b).

In this Comment, I discuss the evolution and current application of the misappropriation theory of insider trading and argue that it simply strays too far from the fraud tenets of Section 10(b) and Rule 10b-5.

A thorough understanding of the misappropriation theory is possible only if one understands how it diverges from the classic theory of insider trading. Therefore, in Section II, I discuss the evolution and present doctrine of classic insider trading. The discussion in this Section focuses on major cases in the development of this theory. Section III presents the misappropriation theory of insider trading. Section III focuses upon (1) the broad scope of the misappropriation theory as initially adopted by the Second Circuit in *United States v. Carpenter*,²⁷ (2) the Circuit's later attempt to limit the scope of the theory in *United States v. Chestman*,²⁸ and (3) the effect that *Chestman* has had on limiting the scope of the theory. Section III ultimately shows that the misappropriation theory strays far from the fraud prohibitions of Section 10(b) and has no identifiable limits, thereby proscribing conduct that is not properly regulated by Section 10(b) and

23. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

24. *Id.* at 1029.

25. *See, e.g.*, *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

26. *See* Christine Murra, Note, *The Misappropriation Theory: A Practical Means of Imposing Rule 10b-5 Liability*, 24 U. RICH. L. REV. 211, 221 (1990) [hereinafter *The Misappropriation Theory*].

27. 791 F.2d 1024 (2d Cir. 1986).

28. 947 F.2d 551 (2d Cir. 1991).

Rule 10b-5. Finally, Section IV presents alternative ways to achieve the valuable public policy of the misappropriation theory.²⁹ Section III concludes that new rules prohibiting the use of material, nonpublic information for an improper purpose should be promulgated under the authority granted to the SEC by Section 10(b).

II. CLASSIC INSIDER TRADING

The regulation of insider trading is based on the assumption that the use of material, nonpublic information in a securities transaction undermines investor expectations of fairness and equal opportunity in the securities markets.³⁰ Individuals who are privy to material,³¹ nonpublic³² information should not be allowed to profit from knowledge of this information unless the knowledge is gained through investigation and skill, not through a position of trust and confidence.³³

A person working for a corporation or an investment house has access to material, nonpublic information based on her position inside the confidential sphere of the entity. With that position comes the corresponding duty to refrain from using the information for personal gain. Use of confidential information within the securities market without disclosure to the rest of the market violates the duty owed to shareholders and is fraud prohibited by Section 10(b) and Rule 10b-5. This is what is meant by the term "insider trading." The scope of the classic theory of insider trading is set out below.

A. *In re Cady, Roberts, Inc.*

The first major development in the application of Section 10(b) to insider trading activities occurred in the 1961 SEC hearing *In re Cady,*

29. The misappropriation theory serves the public interest by expanding the scope of Rule 10b-5 to include more conduct that results from a fiduciary or fiduciary-like duty. See *infra* Section III.

30. Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65 (1984); see *Chestman*, 947 F.2d at 565.

31. Information is material if "there is a substantial likelihood that a reasonable [investor] would consider it important in [deciding whether to buy, sell, or to hold the company's securities, or if it would have] significantly altered the 'total mix' of information made available [to the shareholder]." John I. McMahon, Jr., Note, *A Statutory Definition of Insider Trading: The Need to Codify the Misappropriation Theory*, 13 DEL. J. CORP. L. 985, 986 n.6 (1988) (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

32. Nonpublic information is information that "has not been disseminated in a manner making it available to investors generally." *In re Investors Management Co.*, 44 S.E.C. 633, 643 (1971).

33. *United States v. Carpenter*, 791 F.2d 1024, 1031 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

*Roberts, Inc.*³⁴ This case involved a registered broker-dealer who, while in possession of information concerning a planned dividend cut by a company, directed his clients to liquidate their holdings in that company.³⁵ The broker acquired this information from a corporate insider who owed a fiduciary duty to the shareholders of the corporation.³⁶ The SEC determined that the broker's actions "violated [Rule 10b-5(3)] as a practice which operated . . . as a fraud or deceit upon the purchasers."³⁷ The SEC reasoned that because a corporate insider owes a fiduciary duty to both the shareholders and the corporation itself, using confidential information for personal benefit constitutes fraud. This reasoning has been termed the "disclose or abstain" rule.³⁸

Two factors led the SEC to adopt the disclose or abstain rule. First, the relationship between an insider and the source of the information is such that access to, and use of, the information is only for corporate purposes and not for the insider's personal benefit.³⁹ Second, it is inherently unfair for the insider to take advantage of others in the market who are trading without the benefit of the nonpublic information.⁴⁰ The disclose or abstain rule mandates that the possessor of material, nonpublic information obtained through a fiduciary relationship must either *disclose* the information prior to a securities transaction or *abstain* from trading in the company's securities.⁴¹

B. *Texas Gulf Sulphur Co.*

The disclose or abstain rule advanced in *Cady, Roberts* was expanded in 1968 by the Second Circuit's decision in *SEC v. Texas*

34. 40 S.E.C. 907 (1961).

35. *Id.* at 913.

36. *Id.* at 913. An explanation of how a breach of a fiduciary duty by a corporate insider leads to a transferred duty to the broker-dealer is discussed *infra* Section II.D.

37. *Id.* The broker-dealer was a "tippee" of the corporate insider. See *infra* Section II.D.

38. E.g., William A. Snider, Note, *Securities Law—All in the Family—United States v. Chestman: Finding a Fiduciary or Other Similar Reaction of Trust and Confidence Under Rule 10b-5 for Family Members of a Family Controlled Publicly Traded Corporation*, 16 W. NEW ENG. L. REV. 79, 84 (1994); David Cowan Bayne, *The Insider's Natural-Law Duty: 'Disclose or Abstain'?*, 42 KAN. L. REV. 75, 76 (1993); Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341, 342 n.3 (1982).

39. *Cady, Roberts*, 40 S.E.C. at 913.

40. *Id.*

41. *Id.* at 912. An explanation of how the seller of a security owes a fiduciary duty to the purchaser of a security as a shareholder, prior to purchase, is beyond the scope of this Comment. For an excellent explanation of this theory, see *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

*Gulf Sulphur Co.*⁴² In this case, several officers and directors of Texas Gulf Sulphur Company purchased shares in the corporation's stock based on confidential information relating to an upcoming mine strike.⁴³ The corporate insider defendants also disclosed this information to a number of persons who were not privy to the confidential information.⁴⁴ The court held that the disclose or abstain rule espoused by the SEC was a valid method of attacking insider trading, but found that the scope of the rule should be broader than advocated in *Cady, Roberts*.⁴⁵ The court defined the disclose or abstain rule as requiring *anyone* in possession of material, non-public information to either disclose the information prior to trading or abstain from trading in the corporation's securities.⁴⁶ This broader interpretation ensured that *all* investors had equal access to information.⁴⁷ The court believed that the purpose of Section 10(b) and Rule 10b-5 is to ensure equal access to information by all market participants. In contrast, the SEC believes that the purpose of the enactments is to prohibit insiders from breaching the fiduciary duty owed to corporations and their shareholders.⁴⁸ The rule in *Texas Gulf Sulphur* thus regulated insider trading based on the *nature* of the information possessed by a securities trader and not on *how* the person obtained the information.

Texas Gulf Sulphur introduced significant confusion into the regulation of insider trading. Primarily, a violation of Section 10(b) based on the nature of the information possessed rather than on how the information was obtained greatly expanded the scope of insider trading. Under the broader interpretation of Section 10(b), the use of material, nonpublic information in the securities market is fraudulent in and of itself; there is no requirement that the inside trader first agree to not use the information for personal gain. Additionally, because the SEC was not bound to follow the Second Circuit's decision, a

42. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

43. *Id.* at 839-42.

44. *Id.* at 844.

45. *Id.* at 848.

46. *Id.* The court's definition of the theory read that:

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 chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains disclosed.

Id.

47. *Id.*

48. See generally Suzanne Krudys, Comment, *The Misappropriation Theory: Are the Boundaries Limitless?* 12 U. BRIDGEPORT L. REV. 317 (1991).

dichotomy resulted in the regulation of insider trading.⁴⁹ The SEC applied the more stringent disclose or abstain rule, while the Second Circuit applied the broader disclose or abstain rule, which simply required the possession of material, nonpublic information. The conflict between these two interpretations of Section 10(b) and Rule 10b-5 eventually led to the Supreme Court's involvement in this area.

C. *Chiarella v. United States*

The Supreme Court set out to resolve the discrepancy between the Second Circuit's and SEC's interpretations of the disclose or abstain rule in *Chiarella v. United States*.⁵⁰ Chiarella was an employee of a financial printer.⁵¹ Among the documents that he handled in that position were five announcements of corporate takeover bids. Although the documents did not include the specific targets, Chiarella was able to ascertain which companies were being targeted. He then used this information to purchase stock in the targeted companies.⁵² He sold the stock immediately after the takeover bids were announced, reaping a \$30,000 profit in a fourteen month span.⁵³

In January 1978, Chiarella was indicted on seventeen counts of violating Section 10(b) and Rule 10b-5.⁵⁴ He was subsequently convicted on all counts and appealed his conviction.⁵⁵ A divided Second Circuit affirmed Chiarella's conviction.⁵⁶ The majority followed the reasoning set out in *Texas Gulf Sulphur* and ruled that Section 10(b) and Rule 10b-5 were based on "parity of information," not on violation of a fiduciary duty, as held in *Cady, Roberts*. Thus, the court ruled that "[a]nyone—corporate insider or not—who regularly receives material non-public information may not use that information to trade in securities without incurring an affirmative duty to disclose."⁵⁷

The Supreme Court reversed, explicitly rejecting the "parity of information" rule advanced by the Second Circuit in *Texas Gulf*

49. See, e.g., Douglas M. Branson, *SEC Nonacquiescence in Judicial Decisionmaking: Target Company Disclosure of Acquisition Negotiations*, 46 MD. L. REV. 1001 (1987).

50. 445 U.S. 222 (1980).

51. A financial printer prints documents relating to financial transactions, for example, prospectus or proxy.

52. *Chiarella*, 445 U.S. at 224.

53. *Id.*

54. *Id.* at 225.

55. *Id.*

56. 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

57. *Id.* at 1365.

Sulphur and adopting the breach of fiduciary duty approach advocated by the SEC in *Cady, Roberts*.⁵⁸

The Court presented a very simple two-part rationale for adopting the breach of fiduciary duty approach. First, the use of material, nonpublic information in the securities market for personal gain is fraudulent because a corporate insider owes a fiduciary duty to the corporation and its shareholders. One aspect of a corporate insider's fiduciary duty to the corporation is the requirement that the insider place the shareholder's interest before her own.⁵⁹ Thus, if a corporate insider trades in the corporation's securities without disclosing that she is trading on the basis of material, nonpublic information obtained as a result of her status as a corporate insider, her fiduciary duty to the shareholder is breached.⁶⁰

Second, the Court discussed why the Second Circuit's "parity of information" rule did not apply to insider trading cases. Silence is only fraudulent when a party has a duty to disclose. If no duty to disclose exists, there is no fraud.⁶¹ In this case, Chiarella was not an insider of either corporation involved in the takeover transactions. Thus, he did not owe a duty to the target corporation or to the shareholders of the corporation.⁶² In the absence of a duty to a corporation or its shareholders, Chiarella was not required to disclose his superior knowledge prior to conducting the transactions. He therefore committed no fraudulent act.⁶³ The Court best summed up this argument when it said that while Section 10(b) is aptly described as a catchall provision, "what it catches must be fraud."⁶⁴

The *Chiarella* decision is the foundation of classic insider trading. It recognizes that one cannot be an inside trader unless two criteria are present: (1) information is obtained as a result of a fiduciary relationship between the insider and the corporation whose securities are involved, and (2) the insider trades in those securities without disclosing her superior knowledge.

58. *Chiarella*, 445 U.S. at 232-35.

59. *Id.* at 230.

60. *Id.* at 228. At common law, one who is under a duty to disclose information prior to the consummation of a transaction commits fraud if the information is not disclosed. *Id.* at 227-28. Similarly, to remain silent when one has a duty to disclose material, nonpublic information is fraudulent, and therefore violative of Section 10(b) and Rule 10b-5. *Id.* at 230.

61. *Id.* at 232.

62. *Id.*

63. *Id.* It is important to note that after the Court's ruling in *Dirks v. S.E.C.*, 463 U.S. 646 (1983), Mr. Chiarella would have been guilty of violating Section 10(b) and Rule 10b-5 because of his status as a temporary insider. See *infra* Section II.D.

64. *Chiarella*, 445 U.S. at 235.

Chiarella is also important for a second reason: In Chief Justice Burger's dissenting opinion, the seed for the misappropriation theory of insider trading was planted.⁶⁵ Chief Justice Burger accepted an argument advanced by the United States that *Chiarella* owed a fiduciary duty to his employer, the printing company. Because he obtained material, nonpublic information as a result of his position, *Chiarella* breached the duty owed to his employer and his employer's customers by not disclosing his superior knowledge prior to using it for personal gain.⁶⁶ The majority did not address this issue because it felt it was not reviewable.⁶⁷ While the misappropriation theory of insider trading was not successful as a basis for liability in *Chiarella*, it was certainly noticed.⁶⁸

D. *Dirks v. SEC*

Although the role of classic insider trading was clarified in *Chiarella*, the Supreme Court subsequently reviewed and expanded its scope in *Dirks v. SEC*.⁶⁹ *Dirks* was a securities analyst who specialized in insurance company securities for institutional investors. In March 1973, *Dirks* was contacted by a former officer of Equity Funding, a diversified corporation primarily engaged in selling life insurance and mutual funds. *Dirks* was advised that Equity Funding had drastically overstated its assets and that fraud was rife within the corporation. *Dirks* thereafter conducted his own investigation, verified the fraud within Equity Funding, and advised all of his clients of his findings.⁷⁰ He was subsequently indicted and convicted of aiding and abetting those who sold their stock based on material, non public information.⁷¹ The District of Columbia Court of Appeals affirmed *Dirks'* conviction⁷² and he appealed to the Supreme Court.

The Supreme Court reversed.⁷³ The Court found that *Dirks* did not owe a duty to the shareholders of Equity Funding in his capacity as a "tippee" of the corporate insider; therefore, he had no duty to

65. *Id.* at 239-45 (Burger, C.J., dissenting).

66. *Id.* at 235, 236.

67. *Id.* The jury was not instructed on this potential theory of liability.

68. See *infra* Section III.

69. 463 U.S. 646 (1983). This is one of the few decisions in this area that did not originate within the Second Circuit.

70. *Id.*

71. *Id.* at 650.

72. *S.E.C. v. Dirks*, 681 F.2d 824 (D.C. Cir. 1982).

73. *Dirks v. S.E.C.*, 463 U.S. 646 (1983).

disclose his superior information to shareholders prior to acting on it.⁷⁴ In reaching this conclusion, the Court adopted a three part test to determine if a corporate insider's tippee assumes the tipper's duty to the corporation and its shareholders. First, an insider must breach the fiduciary duty owed to the corporation by disclosing material, nonpublic information.⁷⁵ Second, the tippee must know, or reasonably should know, that the insider breached this duty.⁷⁶ And third, the tippee must trade on the information that was improperly received.⁷⁷

The *Dirks* Court's analysis ended with the first factor of the three step test. The Court stated that in order for an insider to breach her duty to the shareholder by revealing material, nonpublic information she must personally benefit (directly or indirectly) from the disclosure.⁷⁸ Because the corporate insider in the *Dirks* case merely desired to expose the fraud incumbent within Equity Funding and not to benefit personally, the Court found that *Dirks* did not breach any duty owed to the shareholders.⁷⁹ Therefore, *Dirks* could not have inherited a fiduciary duty to the shareholders.⁸⁰

Although *Dirks* was held not to have violated insider trading rules, the Court set out a test that brings many more people within the reach of insider trading laws. The *Dirks* Court went further than merely stating that a tippee may inherit the fiduciary duty of an insider. The Court stated that "temporary" insiders, persons who work for a company that has access to a corporation's material, nonpublic information, may be treated as insiders to the extent that they are privy to nonpublic information.⁸¹ Temporary insider status is only effective if the corporation expects the outsider to keep nonpublic information confidential and the relationship between the parties implies a duty to do so.⁸² Thus, underwriters, lawyers, analysts, reporters, financial printers, or consultants for corporate clients who become privy to nonpublic information, are considered "temporary insiders" and are subject to insider trading liability.

74. *Id.* at 667. A "tippee" is a person who is given non-public information from a corporate insider when no one else is given that information. Krudys, *supra* note 48, at 323.

75. *Dirks*, 463 U.S. at 660.

76. *Id.*

77. *Id.*

78. *Id.* at 662. Examples of benefits from disclosure include pecuniary gain, any quid pro quo, or reputational benefit that may or may not turn into future earnings. *Id.* at 663.

79. *Id.* at 665.

80. *Id.*

81. *Id.* at 655 n.14.

82. *Id.*

Individuals to whom temporary insiders convey material, nonpublic information, as tippees, are also subject to insider trading liability.⁸³

Although the *Dirks* decision greatly expanded the number of persons within the scope of insider trading laws, it allowed for at least two situations in which insiders' disclosure of material, nonpublic information would *not* lead to a violation of insider trading laws. First, an insider may give information to an analyst who is an active trader in the securities of the insider's corporation.⁸⁴ This is a common practice beneficial to the corporation because it allows analysts to more accurately value the corporation's securities.⁸⁵ The insider conveying the information does not receive personal benefit from such a disclosure; thus, the analyst receiving the information is free to trade in the securities of the involved corporation without disclosing his superior information.

Second, an individual with no ties to a corporate insider who happens to overhear a discussion that involves material, nonpublic information has no duty to disclose the information she overhears prior to trading in the corporation's securities.⁸⁶ This scenario fails the second prong of the three part requirement for tippee liability set out in *Dirks*. The tipper had no relationship with the corporate insider; consequently, it would be impossible for the tippee to know that the insider was violating a duty that she owed to her corporation. Therefore, the tippee does not violate Section 10(b) or Rule 10b-5 by trading in the securities of the involved corporation without first disclosing her superior information.

The foregoing analysis constitutes the current structure of the classic insider trading theory. There is no liability unless a corporate or temporary insider breaches a fiduciary duty owed to the corporation or its shareholders. If the insider breaches a duty by relaying material, nonpublic information, liability will not attach to the tippee unless the tippee was aware that the insider both breached a duty and received a benefit from the breach. Thus, in the absence of an insider benefiting

83. *Id.*; See Strauss & Fishbone, *supra* note 6, at *3. It is interesting to note that under this doctrine Mr. Chiarella would be guilty of insider trading on the facts of that case because, as an employee of a financial printer, he was privy to nonpublic information that was intended to remain confidential. Thus, Mr. Chiarella was a temporary insider of the company that hired the printer to do the work.

84. Phillips & Zutz, *supra* note 30, at 83.

85. *Id.*

86. James B. Stewart, *Hot Tips Can Mean Trouble with SEC if You Aren't Careful*, WALL ST. J., July 21, 1989, at A6. This is also a loophole in the *Dirks* holding, but is less of a concern because this type of insider trading is probably much less common than the everyday occurrences in the analyst setting.

from disclosure, there cannot be liability under the classic form of insider trading. It remains a possibility, however, to incur liability under the misappropriation theory of insider trading.

III. MISAPPROPRIATION THEORY

In this Section, I discuss the evolution and current status of the misappropriation theory. I also discuss the probable future of the misappropriation theory and the policy considerations affecting the future expansion or contraction of the theory. The discussion will focus on the major cases in the development of the misappropriation theory.

The misappropriation theory of insider trading greatly expands the scope of events that fall within the ambit of Section 10(b) and Rule 10b-5. The misappropriation theory is based upon a very broad reading of Rule 10b-5.⁸⁷ Under the misappropriation theory, a party is liable for insider trading if she breaches *any* duty owed to *any* party by using material, nonpublic information for personal gain. Under this theory, it is not required that an insider breach a duty owed to the corporation or the shareholders of the corporation whose security is sold in order for liability to attach.⁸⁸

The misappropriation theory is still a young and evolving doctrine. The first mention of the theory did not appear until Chief Justice Burger's dissenting opinion in *Chiarella*.⁸⁹ However, the misappropriation theory was not applied as the sole grounds of liability until the 1986 case of *United States v. Carpenter*.⁹⁰ The *Carpenter* decision gives a limitless interpretation of Section 10(b) and Rule 10b-5, making it possible for *any* person trading in securities, even a person who purchases only one security in their entire life, to be subject to liability under the misappropriation theory.⁹¹ The Second Circuit, realizing *Carpenter's* broad sweep, attempted to limit the scope of the theory in *United States v. Chestman*.⁹² However, the attempt appears to have been unsuccessful because lower courts are not following *Chestman's* narrow holding.⁹³ This leaves the scope and future of the

87. See 17 C.F.R. § 240.10b-5 (1994); *United States v. Carpenter*, 791 F.2d 1024, 1029-30 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

88. See *Carpenter*, 791 F.2d at 1030.

89. See 445 U.S. 222, 239 (1980).

90. See 791 F.2d 1024 (1986).

91. See *id.* at 1032-34.

92. 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

93. See *United States v. Willis*, 737 F. Supp. 269, 271 (S.D.N.Y. 1990) (acknowledging that the Supreme Court has recognized the misappropriation theory but has not yet approved of it by

misappropriation theory up in the air. Moreover, although the theory has never been rejected by any court that has considered it,⁹⁴ and it has been adopted within six federal circuits,⁹⁵ it has never been explicitly accepted by the Supreme Court.⁹⁶

A. *Newman and Materia*

The first two cases to apply the misappropriation theory of insider trading to the acts of securities traders were *United States v. Newman*⁹⁷ and *SEC v. Materia*,⁹⁸ both of which were decided in the Second Circuit. Although these two cases were the first to apply the misappropriation theory, they are not often cited as part of the evolution of the misappropriation theory because they are now considered to fall within the classic theory of insider trading as expanded by the Supreme Court's decision in *Dirks*.

In *Newman*, two of the defendants were employees of different investment banking firms. These two defendants were privy to material, nonpublic information about many corporations because of their roles as advisors for the corporations.⁹⁹ They advised Newman, a securities broker, of material, nonpublic information about the corporations. Newman subsequently used the information to trade in the stock of the corporations. When the information became public and impacted the price of the stock, Newman sold the stock for a large profit.¹⁰⁰ The district court dismissed the complaint against Newman, but the Second Circuit reversed.¹⁰¹ The *Newman* court explicitly adopted the misappropriation theory for the first time.¹⁰² The court held that the two insider defendants violated the duty that they owed to their employer corporations to maintain confidentiality.¹⁰³ This in turn caused the employer to breach the duty it owed to the

a majority of the Court); see also *infra* Section III.D.

94. Hazen, *supra* note 11, at 599.

95. See *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 112 S. Ct. 966 (1992); *SEC v. Peters*, 978 F.2d 1162 (10th Cir. 1991); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *United States v. ReBrook*, 837 F. Supp. 162 (S.D.W.V. 1993), *motion for new trial denied*, 842 F. Supp. 891 (S.D.W.V. 1994).

96. See Hazen, *supra* note 12, at 598.

97. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1982).

98. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

99. *Newman*, 664 F.2d at 15.

100. *Id.* at 15-16.

101. *Id.* at 20.

102. *Id.* at 17.

103. *Id.*

corporations whose securities were traded, resulting in a violation of Section 10(b) and Rule 10b-5.¹⁰⁴

Materia, the second case to apply the misappropriation theory, is factually similar to *Chiarella*. In *Materia*, the defendant was a copy reader for a firm that specialized in printing financial documents. *Materia* acquired confidential information about proposed tender offers from the documents that he read for his employer and used the information to personally trade in the stocks of the affected companies.¹⁰⁵ The Second Circuit upheld the trial court's determination that *Materia* had breached a duty of confidentiality to his employer, which resulted in a violation of Section 10(b) and Rule 10b-5.¹⁰⁶

While these two cases were the first to rely on the misappropriation theory of insider trading, they have since been swallowed by the wider net of the classic theory of insider trading. Subsequent to *Newman*, and the trial court's decision in *Materia*, the Supreme Court decided *Dirks*, in which classic insider trading was extended to those who are "temporary insiders." Thus, factually similar cases to *Newman* and *Materia* will now be decided under the *Dirks*' classic theory of insider trading rather than the misappropriation theory.¹⁰⁷ After *Dirks*, it appeared that the misappropriation theory was short lived. That changed in 1986.

B. *Carpenter*

The misappropriation theory resurfaced as a viable, independent theory of insider trading liability in *United States v. Carpenter*.¹⁰⁸ The Second Circuit's decision in *Carpenter* indicates how wide a net the misappropriation theory casts over insider trading. Defendant Winans was a *Wall Street Journal (Journal)* reporter who wrote the "Heard on the Street" ("Heard") column for the paper. Winans passed on information about upcoming columns to *Carpenter*, a news clerk at the *Journal*.¹⁰⁹ *Carpenter* then relayed the information about the upcoming articles to Winans' broker friends, defendants *Felis* and *Brandt*.¹¹⁰ *Felis* and *Brandt* began trading in the securities of corporations that were the subject of upcoming "Heard" columns.¹¹¹

104. *Id.* at 16.

105. *Materia*, 745 F.2d at 199.

106. *Id.* at 199-201.

107. See *Strauss & Fishbone*, *supra* note 6 and accompanying text.

108. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

109. *Id.* at 1026.

110. *Id.*

111. *Id.* at 1027.

By using the information prior to dissemination to the public through the *Journal*, the group reaped a profit exceeding \$690,000.¹¹² Their activities were eventually discovered by the SEC and Winans, Carpenter, and Felis were charged with violations of Section 10(b) and Rule 10b-5.¹¹³ The trial court, applying the misappropriation theory, found all of the defendants guilty.¹¹⁴

On appeal, the court began its analysis by noting that this case did not fall directly within the ambit of *Newman* or *Materia* because the defendants were not insiders, temporary or otherwise, of the corporations whose stock they traded.¹¹⁵ The court also noted that both Carpenter and Winans were aware that the *Journal* had a policy that nonpublic information acquired on the job was to be held confidential.¹¹⁶ Thus, Carpenter and Winans owed a fiduciary duty of confidentiality to the *Journal*.¹¹⁷

The court next addressed the defendants' argument that the misappropriation theory should not apply in their case. The defendants argued that a breach of their duty of confidentiality to the *Journal* was not sufficient to hold them liable under Section 10(b) and Rule 10b-5. Rather, based on *Newman* and *Materia*, they must owe and breach a duty to the corporation, or to the shareholders of the corporation, whose stocks they purchased or sold based on the confidential information learned at the *Journal*.¹¹⁸

In rejecting this argument, the court began by analyzing *Newman* and *Materia*. The court interpreted these cases to hold that the misappropriation theory proscribes the conversion by "'insiders' or others of material, non-public information in connection with the purchase or sale of securities."¹¹⁹ The court interpreted *Newman* to stand for the proposition that "trading on the basis of improperly obtained information is fundamentally unfair and that distinctions premised on the source of the information undermine the prophylactic

112. *Id.*

113. *Carpenter*, 791 F.2d at 1025. Brandt became the government's key witness in the case. *Id.* at 1026.

114. *United States v. Winans*, 612 F. Supp. 827 (S.D.N.Y. 1985), *aff'd in part and rev'd in part*, *Carpenter*, 791 F.2d 1024 (1986).

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

116. *Id.* at 1026.

117. *Id.*

118. *Id.* at 1029.

119. *Id.* (citing *Materia*, 745 F.2d 197, 203 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985)).

intent of the securities laws."¹²⁰ Moreover, the court noted that the Supreme Court has held on numerous occasions that securities laws combating fraud should be construed not technically and restrictively, but "flexibly."¹²¹ Finally, the court looked to the policies and purposes of Section 10(b) and Rule 10b-5. Focusing on Rule 10b-5, the *Carpenter* court observed that it "prohibits 'any person . . . [from employing] any device, scheme, or artifice to defraud.'"¹²² The Rule also prohibits "any act, practice, or course of business which operates as a fraud or deceit upon any person."¹²³ Finally, the court noted that Section 10(b) of the Act, as implemented by Rule 10b-5, was designed as a catchall clause to prevent all fraudulent practices.¹²⁴ Under this interpretation, the court found that the misappropriation theory was applicable to the facts of the case.

The court then proceeded to analyze each element of Rule 10b-5(c)¹²⁵ under the misappropriation theory. The court began by considering whether the defendants' actions operated as fraud or deceit. *Carpenter* and *Winans* owed a fiduciary duty of confidentiality to the *Journal*. They committed fraud and deceit by misappropriating confidential information for their own benefit and failing to disclose their superior information prior to investing in the securities.¹²⁶ As a result of their actions, the defendants violated Section 10(b), which proscribes fraudulent trading by both insiders and outsiders.¹²⁷

The court next proceeded to the "upon any person" requirement of Rule 10b-5(c). The fraud in *Carpenter* was committed upon *Carpenter's* and *Winans's* employer, the *Journal*.¹²⁸ The court decided that the parties, through their complicity, "perpetrated their

120. *Carpenter*, 791 F.2d at 1029 (quoting *SEC v. Musella*, 578 F. Supp. 425, 438 (S.D.N.Y. 1984)).

121. *Id.* (citing *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386-87 (1983); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)).

122. *Carpenter*, 791 F.2d at 1030.

123. *Id.* at 1029-30 (quoting 17 C.F.R. § 240.10b-5 (emphasis added by Court of Appeals)).

124. *Id.* at 1030 (citing *Chiarella v. United States*, 445 U.S. 222, 226 (1980)).

125. *See supra* note 9.

126. *Carpenter*, 791 F.2d at 1031. The abstain or disclose theory still applies in this area because it is a corollary to the fiduciary duty that defendants owe to the source of the material nonpublic information.

127. *See supra* note 8. A similar conclusion would result if *Carpenter* and *Winans* had stolen material, nonpublic information as traditional corporate insiders or quasi-insiders. The liability of the brokers, *Felis* and *Brandt*, stemmed from their status as tippees of *Carpenter* and *Winans*. *Carpenter*, 791 F.2d at 1031-32.

128. *Id.*

fraud 'upon' the *Journal*, sullyng its reputation and thereby defrauding it 'as surely as if they took [its] money.'"¹²⁹

The court then proceeded to the "in connection with the purchase or sale of any security" requirement of Rule 10b-5(c). The use of misappropriated information for the benefit of the defendants, and to the detriment of those with whom they traded, supported the conclusion that the defendants' fraud was in connection with the purchase or sale of securities.¹³⁰ The court found that the protection of fairness and integrity in the securities markets was the major purpose of Section 10(b) and Rule 10b-5.¹³¹ Further, investors are equally harmed by the fraud of both non-insiders and insiders.¹³²

Finally, the court found that there was a nexus between the fraud in *Carpenter* and the federal regulatory scheme.¹³³ The court reasoned first that the information the defendants misappropriated had absolutely no value to them except "in connection with their subsequent purchases and sales of securities."¹³⁴ Second, the court held that the "in connection with" portion of Rule 10b-5(c) should be interpreted broadly.¹³⁵

Having determined that all of the requirements of Rule 10b-5(c) were present, the court addressed the defendants' final argument. The defendants argued that it was anomalous to hold them liable for using material, nonpublic information for their benefit in the securities market when their employer could lawfully perform the same acts without liability.¹³⁶ In rejecting this argument, the court noted that it was unrealistic to expect the *Journal* to risk its continuing vitality by undertaking such actions.¹³⁷ Further, the relevant question was not what acts the *Journal* could lawfully perform, but rather what actions exposed the defendants to liability.¹³⁸ The defendants had a duty to keep information learned in their capacity as employees confiden-

129. *Id.* (quoting *Newman*, 664 F.2d 12, 17 (2d Cir. 1981)).

130. *Id.* at 1032.

131. *Id.* at 1030.

132. *Id.* at 1032.

133. *Id.* at 1031.

134. *Id.* at 1033.

135. *Id.* at 1032; *Competitive Assocs., Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975)).

136. *Carpenter*, 791 F.2d at 1033.

137. *Id.*

138. *Id.*

tial.¹³⁹ Disclosure of that information violated their fiduciary duty to the *Journal*.¹⁴⁰

Thus, the *Carpenter* court held that when individuals misappropriate material, nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence, and use that information in a securities transaction, they violate Section 10(b) and Rule 10b-5 unless they disclose their superior information to those with whom they trade.¹⁴¹ Because the defendants did not disclose their superior information to the other parties to the transaction, they committed fraud in violation of Section 10(b) as promulgated through Rule 10b-5(c).¹⁴²

The *Carpenter* decision is important for two reasons. First, it is the foundation upon which all future misappropriation cases are based. *Carpenter* is vital to the evolution of the misappropriation theory not only because it revived the theory after it had been subsumed by the *Dirks* decision, but also because the court explicitly described why the misappropriation theory was a valid interpretation of Section 10(b) and Rule 10b-5.¹⁴³ Second, the misappropriation theory is virtually unlimited in scope of application. The *Carpenter* court's very literal, broad reading of Rule 10b-5 suggests that virtually anyone trading in securities may fall within Section 10(b). Merely requiring a breach of any fiduciary duty or a similar relationship of "trust and confidence," and subsequent use of information gained from the breach in the securities market, exponentially increases the number of people who may be affected by these laws. Thus, the Second Circuit, in attempting to broaden the reach of the insider trading laws, created what may be a Pandora's box by not restricting the scope of the misappropriation theory. There is simply no way to know what kind of behavior this rule will encompass because the number and types of fiduciary and fiduciary-like duties are innumerable. The court attempted to remedy

139. *Id.*

140. *Id.* at 1034.

141. *Id.* at 1028-29; see *In re Cady, Roberts*, 40 S.E.C. 907 (1961).

142. *Carpenter*, 791 F.2d at 1034. The Supreme Court granted the defendants' request for certiorari. The Court, however, was evenly divided about whether the defendants had violated Section 10(b) under the misappropriation theory applied by the Second Circuit. Thus, the Court affirmed the convictions, leaving its stamp of approval or rejection of the misappropriation theory for another day. *United States v. Carpenter*, 484 U.S. 19, 24 (1987); see *The Misappropriation Theory*, *supra* note 24, at 221. The Court's affirmation of the lower court's decision carries no precedential value because of an evenly divided court. See Salbu, *supra* note 12, at 232 n.61.

143. *Carpenter*, 791 F.2d at 1029.

this problem in its next major misappropriation theory case, *United States v. Chestman*.¹⁴⁴

C. *United States v. Chestman*

In 1990, the Second Circuit was faced with the ramifications of its sweeping decision in *Carpenter*. After a three judge panel of the court reversed defendant Chestman's conviction for insider trading violations based on the misappropriation theory, the court agreed to rehear the case *en banc*.¹⁴⁵ The complexity in *United States v. Chestman* was the unusual nature of the facts that gave rise to the defendant's conviction.

Robert Chestman was a broker and financial advisor for Keith Loeb.¹⁴⁶ Loeb's wife Susan was the niece of the president and controlling shareholder of Wauldbaum, Inc., a fact of which Chestman was aware.¹⁴⁷ In 1986, Wauldbaum entered negotiations to sell Wauldbaum, Inc. to Great Atlantic and Pacific Tea Company, Inc. (A&P).¹⁴⁸ Upon reaching an agreement to transfer control of Wauldbaum, Inc. to A&P, Wauldbaum advised his sister, Shirley Witkin, that he would tender her Wauldbaum, Inc. shares to A&P along with his own.¹⁴⁹ Wauldbaum also advised his sister to keep the transfer information confidential and not to discuss it with anyone.¹⁵⁰

Three days after she tendered her shares to her brother, Ms. Witkin told her daughter, Wauldbaum's niece, that she had just returned from tendering her shares in Wauldbaum, Inc. to her brother and that the company was in the process of being sold.¹⁵¹ Ms. Witkin also admonished Susan Loeb not to tell anyone except her husband, Keith, about the deal because the deal was beneficial for the company and if word got out the deal could be ruined.¹⁵² The next day, Ms. Loeb told her husband about the impending deal involving Wauldbaum, Inc., and advised him not to tell anyone.¹⁵³

The following day, Loeb phoned Chestman and advised him that he "had some definite, some accurate information" that Wauldbaum, Inc. was in the process of being sold.¹⁵⁴ Chestman stated that he

144. 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

145. *Id.* at 554.

146. *Id.* at 555.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. *Id.*

154. *Id.*

could not advise Loeb how to proceed because the information that Loeb possessed was nonpublic.¹⁵⁵ However, several minutes later Chestman purchased 3,000 shares of Wauldbaum, Inc. stock for his own account.¹⁵⁶ Later that morning, he purchased over 8,000 shares of Wauldbaum, Inc. stock for his discretionary accounts.¹⁵⁷ Finally, just before the market closed for the day, Loeb phoned back and again asked Chestman for his advice. Chestman would only say that based on his research, Wauldbaum, Inc. was a "buy."¹⁵⁸ Loeb thus placed an order for 1,000 shares of Wauldbaum, Inc. stock.¹⁵⁹ The sale of Wauldbaum, Inc. was announced after the market closed for the day and the value of Wauldbaum, Inc.'s shares increased by over thirty percent the next day.¹⁶⁰

The nonpublic information that Chestman possessed prior to the announcement of the sale of Wauldbaum, Inc. was eventually discovered. Loeb agreed to testify for the government against Chestman.¹⁶¹ Chestman was tried as the tippee of Loeb. Under the misappropriation theory, it was Loeb who must have violated a duty of confidentiality that he owed to either his wife or the Wauldbaum family.¹⁶² If the government was unable to show that Loeb violated a fiduciary duty, then Chestman could not be held liable as his tippee. The jury, however, found that Loeb violated the fiduciary duty that he owed to both his wife and the Wauldbaum family.¹⁶³ Chestman was found guilty of ten violations of Rule 10b-5 because he was a tippee of Loeb.¹⁶⁴ Chestman appealed his conviction to the Second Circuit, arguing that there was insufficient evidence to sustain his conviction. The three judge panel reversed Chestman's conviction on all

155. *Id.* This indicates that Mr. Chestman at least had a suspicion that Mr. Loeb was in possession of material, nonpublic inside information.

156. *Id.*

157. *Id.*

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.* at 555-56.

162. *Id.* at 564. Mr. Loeb was the person who had to have violated a fiduciary duty because he was dealing with Mr. Chestman in an arms length manner, thus Mr. Chestman owed no duty to Mr. Loeb. However, if Mr. Loeb violated a duty of confidentiality and Mr. Chestman was aware of the breach, he would be a tippee of Mr. Loeb. See *Dirks*, 463 U.S. 646 (1983); *supra* Section II.D.

163. *United States v. Chestman*, 704 F. Supp. 451 (S.D.N.Y. 1989), *rev'd*, 903 F.2d 75 (2nd Cir. 1990), *vacated*, 947 F.2d 551 (2nd Cir. 1991) (en banc).

164. *Id.* Mr. Chestman was also found guilty of violating several other securities laws. These violations are beyond the scope of this Comment.

counts.¹⁶⁵ However, the full court agreed to re-hear the matter *en banc*.

The *en banc* court was divided. By a six to five majority, the court overturned Chestman's Rule 10b-5 convictions.¹⁶⁶ The majority emphasized the importance of its ruling in *Carpenter* because it represented the first time that the traditional "fiduciary-shareholder" relationship of the classic theory of insider trading had been abandoned and the "fraud on the source" theory had been adopted.¹⁶⁷ As long as the requisite fiduciary duty was tethered to the fiduciary-shareholder context, as in classic insider trading, the scope of insider trading was quite narrow. However, the presence of fiduciary duties in other areas, as in *Carpenter*, was anything but clear, making the scope of the rule unclear. The court stated its goal was to tread cautiously in extending the misappropriation theory to relationships outside the employer-employee relationship for fear that the doctrine would take over "the whole corporate universe."¹⁶⁸

The *Chestman* court began its analysis by considering which relationships would satisfy the *Carpenter* requirement that a "fiduciary duty or similar relationship of trust and confidence" exist.¹⁶⁹ The court first focused on what constituted a fiduciary duty. After stating that the existence of family relationships or the act of placing trust in another person does not automatically create a fiduciary duty, the court compiled a non-exclusive list of common law fiduciary relationships. These relationships include: Attorney-client, executor-heir, guardian-ward, principal-agent, trustee-trust beneficiary, and senior corporate official-shareholder.¹⁷⁰ The court had no difficulty finding that the relationships between Loeb and his wife and Loeb and the Wauld-baum family were not fiduciary relationships according to the court's definition.¹⁷¹

165. *United States v. Chestman*, 903 F.2d 75 (2d Cir. 1990), *vacated*, 947 F.2d 551 (2nd Cir. 1991) (*en banc*).

166. *Chestman*, 947 at F.2d 554.

167. *Id.* at 567. Fraud on the source refers to owing a fiduciary duty to the source of the material nonpublic information, which is not the corporation whose securities are traded. For example, in *Carpenter*, the defendants' acts were a fraud on the Wall Street Journal and they were the source of the information, thus the term "fraud on the source." While classic insider trading may also involve the use of information produced by the corporation for one's own benefit (a fraud on the source), courts usually rely on the fiduciary duty owed directly to the shareholders in finding fraud in classic insider trading situations. See *Chestman*, 947 F.2d at 567.

168. *Chestman*, 947 F.2d at 567.

169. *Id.* The court was apparently concerned with restricting the limitless definition of the misappropriation theory that it created in *Carpenter*.

170. *Id.* at 568.

171. *Id.*

The court next considered whether there existed a "similar relationship of trust and confidence" between either Loeb and his wife or Loeb and the Wauldbaum family.¹⁷² Because the essence of a fiduciary relationship is the reposing of confidence and reliance in one party and the exercise of de facto control and dominance by the other party,¹⁷³ the court found that a "similar relationship of trust and confidence" should be limited to relationships where one party is given access to confidential information for the benefit of the other, subject to the other's discretion.¹⁷⁴

In applying this standard, the court found that Loeb had never been trusted with confidential information within the Wauldbaum family; he was never part of the family's "inner circle" or its business; the information had been gratuitously provided to Loeb by his wife.¹⁷⁵ Therefore, the court did not find a "similar relationship of trust and confidence" between Loeb and the Wauldbaum family.¹⁷⁶

Finally, the court considered whether Loeb had a "similar relationship of trust and confidence" with his wife. Reemphasizing that familial relations alone are insufficient to satisfy this requirement, the court noted that the only evidence of a relationship of trust and confidence between the couple was that Mrs. Loeb advised her husband to keep the Wauldbaum, Inc. information confidential and that the two had shared confidences in the past. There was insufficient evidence to hold that the information communicated between Mrs. Loeb and her husband was to be kept secret based on an implied fiduciary relationship.¹⁷⁷ The evidence did not indicate that Mrs. Loeb informed her husband of the information so that he could use it in a form that would be of benefit to her. The evidence did not even indicate that the two were in the habit of sharing business confidences with one another. Thus, because Loeb did not expressly accept a duty to keep the information confidential, and because there was no indication of a fiduciary-like relationship between the spouses, Loeb did not breach a "similar relationship of trust and confidence" as to his

172. *Id.*

173. *Id.* (citing *United States v. Margiotta*, 688 F.2d 108, 125 (2d Cir. 1982), *cert. denied*, 461 U.S. 913 (1983)).

174. *Id.* at 568-69.

175. *Id.*

176. *Id.* at 570-71.

177. *Id.* at 571.

wife.¹⁷⁸ Therefore, the court held that the conviction of Chestman under Section 10(b) and Rule 10b-5 should be reversed.¹⁷⁹

The five member dissent argued that the majority allowed form to rule over substance.¹⁸⁰ They noted that the Wauldbaum family consistently mixed family and business relationships; thus, Loeb had sufficient access to inside information and should have been required to abstain from trading in Wauldbaum, Inc. securities unless he disclosed his superior information prior to trading.¹⁸¹ The dissent also argued that the majority's failure to find a duty to maintain confidentiality in situations where corporations are closely held within a family will allow more confidential information about a small corporation to get to the market than information about a large publicly held corporation.¹⁸² In the dissent's view, Loeb breached a fiduciary duty owed to his in-laws; therefore, Chestman could have been considered a tippee of Loeb.¹⁸³

The majority's decision in *Chestman* indicates the court's desire to retreat from the broad scope of the misappropriation theory adopted in *Carpenter*. The court went to great pains to place a definable limit on the type of fiduciary or fiduciary-like duty that, if breached, satisfies the misappropriation theory. This attempt to limit the scope of the theory, however, is not very effective. In attempting to bring the theory into a more direct relationship with traditional securities activities, the court relied on principles from agency, tort, and basic common law, not securities law.¹⁸⁴ This step only makes the scope and desired purpose of the misappropriation theory more confusing.

Section 10(b) and Rule 10b-5 are designed to prevent fraud "in connection with" the purchase or sale of securities.¹⁸⁵ Courts have always given a very broad and expansive reading to the "in connection

178. *Id.*

179. *Id.*

180. *Chestman*, 947 F.2d at 571 (Winter, J., dissenting).

181. *Id.* at 579-81.

182. *Id.* at 580. The dissent set forth its own three part test to determine whether the disclose or abstain rule should apply to a family member. This test would require a family to disclose superior information or abstain from trading if: (i) she has received or expects (e.g., through inheritance) benefits from family control of a corporation, (ii) is in a position to learn confidential corporate information through ordinary family interactions, and (iii) knows that under the circumstances both the corporation and the family desire confidentiality. Under this test the dissent found that Mr. Loeb had to abstain or disclose with regard to the information that he conveyed to Mr. Chestman. *Id.*

183. *Id.* at 581.

184. See generally, Anderson, *supra* note 38.

185. 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1994).

with" standard.¹⁸⁶ This does not pose a problem within the classic insider trading theory because the fraud connected with the traditional shareholder-fiduciary relationship is closely tied to the securities transaction.¹⁸⁷ However, in *Carpenter*, the court expanded the types of relationships that could lead to a fraud in connection with the purchase or sale of securities,¹⁸⁸ and made the field of insider trading all the more confusing. *Carpenter* developed misappropriation theory into a mixed-type theory, in which a non-securities related relationship could unknowingly lead to a violation of a securities related law.

The *Chestman* court realized the broad scope and confusion created by the *Carpenter* decision and therefore attempted to restrict its effect by enforcing more traditional securities related problems.¹⁸⁹ After *Chestman*, courts must analyze the status of a particular relationship to determine if it is a traditional fiduciary relationship at common law, in agency, or in tort in order to determine if the relationship is traditionally one of trust and confidentiality. Only upon an affirmative response to one of these inquiries is one able to determine if the status of a particular relationship does or does not violate the ever expanding misappropriation theory. Securities law is thus becoming increasingly based on a nonsecurity analysis, reducing the effectiveness of laws that attempt to target securities markets.

The *Chestman* decision leaves the role of the misappropriation theory unclear. The seminal case in this area, *Carpenter*, turns on the court's attempt to broaden the scope of the insider trading laws. However, *Chestman* downplays the criteria that *Carpenter* utilized to broaden the misappropriation theory, although it affirms its viability. After *Chestman*, lower courts and all participants in the securities market were in a position of great confusion. The lower courts quickly began to interpret the *Chestman* and *Carpenter* decisions.

D. The Willis Cases

The Second Circuit's attempt to restrict the misappropriation theory was immediately tested in the Southern District of New York case of *United States v. Willis*.¹⁹⁰ In this sub-section, I will focus on

186. See, e.g., *United States v. Carpenter*, 791 F.2d 1024, 1033 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811, 815 (2d Cir. 1975).

187. See *Carpenter*, 791 F.2d at 1033.

188. *Carpenter*, 791 F.2d 1024.

189. *Chestman*, 947 F.2d 551.

190. 778 F. Supp. 205 (S.D.N.Y. 1991). Four court opinions resulted from the facts of this case. The first opinion included only Mr. Willis as a defendant in a motion that the indictment

the analysis of the *United States v. Willis* opinions. I will also discuss the effect the *Willis* cases will have on the future of the misappropriation theory.

United States v. Willis, arguably, is a case that makes application of the misappropriation theory through the use of Rule 10b-5 the most difficult to comprehend. Willis was a psychiatrist who treated the wife of a very prominent businessman, Sanford Weill.¹⁹¹ During several sessions with Mrs. Weill, Willis learned that Mr. Weill was deeply involved in a potential transaction with a large bank and that the transaction, if successful, would have a significant effect on the bank's stock.¹⁹² Based on this information, Willis purchased over 13,000 shares of the bank's stock. After the information that he learned from Mrs. Weill was made public, Willis sold the shares for a profit of over \$27,000.¹⁹³ Willis was subsequently charged with violation of insider trading laws based on his use of information that he misappropriated from Mrs. Weill.¹⁹⁴ Willis initially pleaded guilty to the charges against him, but in light of the *Chestman* decision, filed a motion for withdrawal of his plea and moved to have all charges against him dismissed.¹⁹⁵ The court granted Willis' request to withdraw his guilty plea and then considered his motion that all charges be dismissed.¹⁹⁶

Willis advanced two arguments in support of his motion. First, he argued that Mrs. Weill's status as the spouse of a corporate insider was insufficient to create a fiduciary or fiduciary-like duty upon Mrs. Weill.¹⁹⁷ Second, Willis argued that according to *Chestman*, there must be an unbroken chain of confidentiality from the insider, to the

against him be dismissed. *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990) [hereinafter *Willis I*]. The second opinion to result from this fact pattern involves only one of Mr. Willis' co-defendants in a motion that the complaint against him be dismissed. *SEC v. Willis*, 777 F. Supp. 1165 (S.D.N.Y. 1991) [hereinafter *Willis II*]. The third opinion resulting from this set of facts is one resulting from another request by Mr. Willis that the indictment against him be dismissed. *United States v. Willis*, 778 F. Supp. 205 (S.D.N.Y. 1991) [hereinafter *Willis III*]. Finally, the same co-defendant that is the subject of *Willis II* is the subject of an opinion concerning his motion to reargue his case in light of the Second Circuit's en banc decision in *Chestman*. *SEC v. Willis*, 787 F. Supp. 58 (S.D.N.Y. 1992) [hereinafter *Willis IV*]. The primary focus of this discussion is *Willis III*.

191. *Willis I*, 737 F. Supp. at 271. While *Willis III* is the case of greatest importance, the court in *Willis III* referred to *Willis I* for the facts of the case. Accordingly, facts are taken from *Willis I* and discussion of the court's ruling will focus on *Willis III*.

192. *Id.*

193. *Id.*

194. *Id.*

195. *Willis III*, 778 F. Supp. at 206.

196. *Id.*

197. *Id.* at 208 (citing *Chestman*, 947 F.2d at 568).

intermediary(s), to the person who ultimately used the information for personal gain.¹⁹⁸ Under this logic, Willis argued, Mrs. Weill was under no fiduciary duty to keep information acquired from her husband confidential; thus, the information lost its confidentiality as to anyone she informed.¹⁹⁹ Therefore, Willis did not misappropriate the information from Mrs. Weill.²⁰⁰ The court found no need to assess Willis' first argument because it found that his second argument had no merit.²⁰¹

The court found Willis' argument that an unbroken chain of confidentiality is required to create a fiduciary or fiduciary-like duty misapplied the misappropriation theory.²⁰² The important relationship is not the relationship between the insider and the confidant, but rather the relationship between the misappropriator and the person from whom the information was misappropriated.²⁰³ This rule is based on the misappropriation theory's focus on any breach of a fiduciary or fiduciary-like duty and the lack of a requirement that the breach of a duty relate to a corporation or its shareholders.²⁰⁴ For example, in *Chestman*, it was the relationship between Loeb and his wife that was critical, not his wife's relationship with her mother or her uncle.²⁰⁵

The Second Circuit noted that the relationship between Willis and Mrs. Weill was pertinent because Willis was the one who misappropriated the information for his own benefit.²⁰⁶ The court found a fiduciary relationship between the two based on Willis' oath of confidentiality as to anything learned while treating patients.²⁰⁷ While the court conceded that this was not one of the traditional relationships enumerated by the *Chestman* court, it held that the concerns of the *Chestman* court were directed towards "amorphous relationships of trust and confidence that are not inherently fiduciary and recognized as such."²⁰⁸ The *Willis III* court found that the

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.* at 209.

206. *Id.*

207. *Id.*

208. *Id.* It is interesting to note the role that *Chestman* played in the case of one of Mr. Willis' co-defendants in *Willis II*. The defendant in this action also sought to have his indictments dismissed on the grounds of the *Chestman* decision. In denying this motion, the judge gave *Chestman* a very small role in the evolution of the misappropriation theory. The judge

doctor-patient relationship is an inherently and well recognized fiduciary relationship.²⁰⁹ Therefore, the court found that Willis did misappropriate the information that he learned from Mrs. Weill. Willis had a corresponding duty to either disclose his superior information prior to trading in the banks' securities or abstain from trading in them.²¹⁰ Because he did not disclose his superior information prior to using the information in the securities market, the court denied Willis' motion requesting that all charges against him be dropped.²¹¹

Willis III and *IV* indicate that lower courts do not view *Chestman* as limiting the scope of the misappropriation theory, as the *Chestman* court desired. Rather, lower courts view *Chestman* as an affirmation of the theory and nothing more.²¹² Contrary to the *Chestman* court's attempt, the *Willis* court used *Chestman* to broaden the misappropriation theory, expanding the types of fiduciary duties that satisfy this theory. *Chestman* thus reaffirmed the Second Circuit's commitment to the theory, allowing lower courts more comfort to reach non-traditional securities violations.²¹³

The *Willis* decision further indicates how far the misappropriation theory is removed from the securities market. In *Willis*, the harm resulting from the breach of the fiduciary duty that Willis owed to Mrs. Weill was that Mrs. Weill would have to either find a new psychiatrist or spend more time in treatment with Willis in order to resolve her stress caused by the incident.²¹⁴ The breach and the resulting harm had no tie to the securities market at all. Although the breach of Willis' fiduciary duty did have an effect on the securities market, holding Willis liable strays far from the underlying tenet of securities regulation—protecting investors' expectation of fairness and equal opportunity in the market.²¹⁵ Willis' breach of the duty, and the resulting harm to Mrs. Weill, had no effect on the fairness or equal

found that *Chestman* "fashioned no new rules of liability with respect to the misappropriation theory. On the contrary, the Second Circuit simply found that there was insufficient evidence to establish that a required element of the misappropriation claim had been satisfied—namely, that there be a breach of a fiduciary relationship or other similar relationship of trust and confidence." *Willis IV*, 787 F. Supp. 58, 61 (S.D.N.Y. 1992). Thus, similar to the *Willis III* court, this court held that *Chestman* clarified, but did not restrict, the scope of the misappropriation theory. *Id.*

209. *Willis III*, 778 F. Supp. at 209.

210. *Id.*

211. *Id.*

212. *See id.*; see also Strauss & Fishbone, *supra* note 6 and accompanying text.

213. *See* Strauss & Fishbone, *supra* note 6, at *12.

214. *Willis*, 737 F. Supp. at 274.

215. *See* Phillips & Zutz, *supra* note 30.

opportunity of investors in the market. Willis thus falls within the ambit of insider trading laws primarily because of the wide interpretation that the misappropriation theory gives to Section 10(b) and Rule 10b-5.²¹⁶

The *Willis III* and *IV* decisions are troubling for one other reason: A determination that information is misappropriated based merely on the presence of a fiduciary or fiduciary-type duty creates an inequity within the law. Willis' misappropriation of the information from Mrs. Weill resulted from the fiduciary duty he owed her, despite the fact that Mrs. Weill did not owe a fiduciary duty to her insider husband.²¹⁷ If Mrs. Weill were to leave Willis' office and tell her golf partners the exact same information, and they later used the information to trade in the securities of the affected companies, they would not have misappropriated information because they owed her no fiduciary or fiduciary-like duty. An inequity is thus created.

The above scenario presents a problem because insider trading laws will be applied based on the relationship between two parties and not the status of the information possessed. The same information in the hands of Willis and Mrs. Weill's golf partner(s) will have the same effect on investors' expectations and fairness in the securities markets. Therefore, one party should not be allowed to profit while the other party is subject to liability.

The foregoing scenario exposes the root problem presented by insider trading laws as broadly as does the misappropriation theory. Although the misappropriation theory brings many transactions within the scope of insider trading laws, it does so arbitrarily and inequitably. It is not my contention that the use of material, nonpublic information by either Willis or Mrs. Weill's golf partners should go unpunished; rather, punishing the behavior under the rubric of committing a fraud in relation to the sale or purchase of securities is not proper.

The breach of fiduciary duty requirement works well within the classic insider trading theory.²¹⁸ A breach of a duty does not occur unless an insider gains a benefit,²¹⁹ which only occurs if the information is used in the securities market.²²⁰ Thus, in classic insider trading, transactions that undermine the central goals of securities

216. See *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971).

217. *Willis III*, 778 F. Supp. at 208.

218. See *supra* Section II.D.

219. See *supra* Section II.D.

220. See *supra* Section II.D.

regulation, expectations of fairness and equal opportunity, are prohibited by the insider trading laws.

The same cannot be said about the misappropriation theory. The use of material, nonpublic information in a securities transaction only leads to a breach of a fiduciary duty if the person trading on the information owes a fiduciary duty to the person from whom she obtained the information, *and* the fiduciary does not disclose her superior knowledge prior to using it to her benefit. However, whether or not a fiduciary duty is breached by the transaction, investors' expectations of fairness and equal opportunity are equally undermined by the use of the material, nonpublic information in the securities markets. Thus, focusing on the relationship between the misappropriator and the informer does not adequately protect the overall goals of securities regulation—protecting investors' expectations of fairness and equal opportunity.

In addition to exposing the root problem of the misappropriation theory, the *Willis* cases illustrate why the Supreme Court needs to rule on the viability and scope of this theory.²²¹ A Supreme Court ruling will give all courts a benchmark to follow in the development of the theory. Until such time, lower courts are likely to contract and expand the theory to fit the current climate of the courts and the general public as well as the facts of the particular case. This leaves the courts and defendants in a very precarious and unenviable position of uncertainty.

The *Willis* cases, relying on the *Chestman* court's reaffirmation of the misappropriation theory, and working around the court's desire to limit the scope of the theory, further indicates the viability and broad scope of the theory. The information *Willis* learned from Mrs. Weill was less confidential than the sale of Waldbaum, Inc., information to which Loeb had access, yet *Willis* was held to have violated insider trading laws. *Chestman* appears to be nothing but a fact specific hazard in the road to expansion of the misappropriation theory. Therefore, the *Chestman* court's fear that the theory will take over the "whole corporate universe" remains a distinct possibility.²²²

221. The Court's only attempt to rule in the area ended in an evenly divided Court confirming the lower court's ruling. See *supra* note 142.

222. *United States v. Chestman*, 947 U.S. 551, 567 (2d Cir. 1991), cert. denied, 112 S. Ct. 1759 (1992) (citing *United States v. Chiarella*, 588 F.2d 1358, 1377 (2d Cir. 1978), rev'd, 445 U.S. 222 (1978)).

IV. EFFICACY OF THE MISAPPROPRIATION THEORY AND SUGGESTIONS FOR CHANGE

The misappropriation theory is an attempt to achieve a commendable goal through the wrong vehicle. Few would argue that attempts to eradicate the benefits enjoyed by those using material, nonpublic information in the securities market is not a worthy goal.²²³ However, use of traditional insider trading laws is not the proper vehicle to carry out this goal. This Section discusses why the misappropriation theory should be implemented through a vehicle other than the traditional insider trading laws.

Section 10(b) and Rule 10b-5 were created by Congress and the SEC to prevent the traditional corporate insider or quasi-insider from using her position for personal gain, and from undermining investors' expectations of fairness and equal opportunity in securities markets.²²⁴ The rules work well for this purpose in the classic insider trading sphere. However, application of these rules to persons who do not fall within the classic insider trading theory requires an incredibly broad reading of the phrase "in connection with" and a contortion of the requirement, found in Rule 10b-5, that "any device, scheme or artifice to defraud" be employed.²²⁵ The attempt to stretch the insider trading rules to cover nontraditional inside traders results in inconsistent and unpredictable results.²²⁶

To resolve the problems created by the misappropriation theory, and to fill the holes within the classic and misappropriation theories of insider trading, a new set of regulations should be adopted. Section 10(b) of the Act gives the SEC the authority to promulgate rules relating to manipulative or deceptive devices or practices that are used to purchase or sell any registered security.²²⁷ Consistent with this authority, the SEC could adopt regulations that seek to achieve the same ends as the misappropriation theory without having to fit complaints within the framework of Rule 10b-5. In considering potential frameworks, the Commission should assess how the framework will apply to problems incumbent in the misappropriation theory, and to debt instruments to which the current regulatory structure does

223. *But see* HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* 93-110 (1966).

224. *See* Salbu, *supra* note 12; Phillips & Zutz, *supra* note 30, at 65.

225. *See* 17 C.F.R. § 240.10b-5 (1994).

226. *Compare* Willis, 778 F.2d 205 (2d Cir. 1991), *with* Chestman, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

227. 15 U.S.C. § 78j(b) (1988).

not apply because there is no fiduciary duty owed to the owners. Three broad frameworks could satisfy these objectives. First, a rule could require an unbroken fiduciary chain from the misappropriator of the material, nonpublic information down to the person who uses the information in the securities markets. Second, regulations could be based on the improper use of material, nonpublic information obtained through a special relationship. Finally, regulations could be based on the status and nature of the information possessed and not on the presence or absence of a fiduciary duty. Each of these frameworks is discussed below.

The first possible solution is a broad framework that follows the argument of Willis that liability requires an unbroken fiduciary chain leading from the insider to the misappropriator. This framework will resolve the problems of inequity but will require careful drafting to avoid requiring individuals to assess whether there has been a break in the fiduciary chain. If regulations are not carefully drafted, a great deal of analysis on the part of the misappropriator is required, leaving the ultimate outcome largely in the hands of the court. Moreover, it does not alleviate the problem faced by the *Chestman* court, namely, defining the nature and scope of a fiduciary relationship or duty. Therefore, this particular approach is not much of an improvement.

A second solution that may alleviate the problems created by the misappropriation theory is one actually advocated in classic insider trading theory.²²⁸ Under this approach, a person trading in securities will violate Section 10(b) if she acquires material, nonpublic information through a special relationship and uses the information for an improper purpose.²²⁹ An improper purpose is one not authorized or expected by the person conveying the information.²³⁰ A special relationship exists where the trader acquires information as a result of a business, friendship, or other similar relationship. This concept is easily understood by applying it to the facts of *Willis*. Willis had a business relationship with Mrs. Weill and nonpublic material information was conveyed to him in his capacity as her psychiatrist. Proper use of this information by Willis would have been to analyze her thoughts and feelings and to assist her to feel better. It was improper for him to use the information in the securities market. Because he was not told the information for his personal gain, its use in the securities market was a violation of Section 10(b).

228. Phillips & Zutz, *supra* note 30.

229. *See id.* at 99.

230. *Id.*

While the improper purpose proposal works well in the above example, it is less clear how well it will work if Mrs. Weill gives the information to her golf partner(s). The information could be viewed as gossip and not intended to be acted upon, in which case its use in the securities markets would be a violation of Section 10(b). The scenario could also be viewed as information that was conveyed as the result of a personal relationship between the two parties, in which case its use is barred in the securities market altogether. Who decides what is, and is not, a personal relationship? While these problems could be resolved by drafting a new rule under Section 10(b), delineating such special relationships will likely result in courts contracting and expanding the Rule's terms, as is occurring with the current rule.

A final potential solution the SEC should consider is one that focuses on the nature of the information possessed and not the status of the person that uses the information in the securities market. This structure removes the assessment of whether a fiduciary duty is present and places a stringent requirement on people trading in the securities market to determine if the information is material and nonpublic. This approach is attractive because it could be drafted so that a party is liable for trading with material, nonpublic information unless they can show a good faith determination that the information was public. Applying this approach to the golf partner example is easier than trying to apply the other two approaches. Mrs. Weill's husband, as a bank executive, is the classic insider. When he told his wife of the impending bank transaction, he did not violate this proposed rule because he did not gain any benefit.²³¹ Under this proposal, Mrs. Weill is not liable because she has not traded in the securities market and receives no benefit from her golf partners' use of the information in the securities markets. The golf partners, however, would be required to ascertain the public nature of the information prior to investing in the securities of the affected bank or be subject to liability for insider trading. In this scenario, the golf partner(s) would not be able to make a good faith showing that the information was public; therefore, their actions constitute insider trading. This proposal adheres more closely to the underlying tenets of securities regulation—investors' expectations of fairness and equal access; any person trading in securities without a good faith belief in the public nature of information violates this theory.

The foregoing suggestion, to regulate insider trading based on the status of information possessed, parallels the framework struck down

231. See *supra* Section II.D.

by the Supreme Court in *Chiarella*. My proposal can, however, be reconciled with *Chiarella*. The *Chiarella* Court rejected the possession of material, nonpublic information argument because if a person was not an insider, quasi-insider, or tippee of an insider they did not owe a fiduciary duty to the corporation whose securities were involved. Because a breach of a fiduciary duty is required to find a violation of Rule 10b-5, no violation could occur without such a fiduciary duty. However, because I am advocating the adoption of a new rule promulgated under Section 10(b), the *Chiarella* decision is not implicated. The entire purpose of the promulgation of a new rule is to get away from the fiduciary duty requirement. Cases requiring such a duty are thus not directly binding on matters brought under the new rule.

A second problem with the use of Section 10(b) and Rule 10b-5 as vehicles for the regulation of insider trading is the inability of the laws to regulate the trading of debt instruments by insiders. Debt instruments involve a contractual relationship between a corporation and holders of the instruments. It is impossible for an insider to breach any fiduciary duty to a holder of a debt instrument because the insider only owes the debt holder the duty of good faith and fair dealing in carrying out the contract terms. Therefore, under the current insider trading theories, it is not possible for an insider to be held liable for using material, nonpublic information to invest in the corporation's debt instruments.²³² The debt instrument problem indicates the need for an additional regulation, one not focusing on the presence of a fiduciary duty, to enforce insider trading laws.

The current lack of a fiduciary duty in debt instrument trading supports the promulgation of a rule that regulates insider trading based upon the status of the information and not based upon the presence of a fiduciary duty. Such a theory applies equally as well to debt instruments as to equity instruments. Thus, it would not matter what type of instrument a person trades. The use of material, nonpublic information in a securities transaction, without a good faith belief that the information is public, or without first disclosing the information, leads to a violation of Section 10(b).

The misappropriation theory, while attempting to achieve a very worthy and much needed goal, is saddled with poor vehicles with

232. This problem indicates a second way in which the misappropriation theory is inequitable in the manner in which it brings additional behavior within the scope of the insider trading laws. Two identical fact patterns could have different results based on the status of the involved security as an equity instrument or a debt instrument.

which to carry out its purpose: Section 10(b) and Rule 10b-5. Promulgation of new rules under the authority provided by Section 10(b) would allow the policy behind the misappropriation theory to live on, while discarding the incompatible wagon to which it is hitched. New rules that focus on an unbroken fiduciary chain, or ideally upon the status of the information possessed, will greatly increase the equity and predictability of the misappropriation theory. The promulgation of new rules will bring nontraditional inside traders of debt and equity instruments within the scope of insider trading laws.

V. CONCLUSION

Insider trading is a very difficult area to regulate because of the lack of statutory definition for insider trading. The SEC and federal courts have been left to delineate what activities constitute insider trading. Unfortunately, this type of scheme has largely led to determinations on a case by case basis and to different interpretations of the scope of insider trading by different regulatory bodies.

A consensus has been reached regarding some aspects of insider trading. After the Supreme Court decided *Dirks v. SEC*,²³³ the scope of classic insider trading was greatly solidified. Classic insider trading focuses on the breach of a fiduciary-shareholder relationship as the fraud required under Section 10(b) and Rule 10b-5. The *Dirks* decision also solidified which persons are considered insiders based on their access, permanent or temporary, to material, nonpublic information. Thus, *Dirks* cleared up ambiguities regarding the scope of classic insider trading theory. Unfortunately, it also marked the beginning of the misappropriation theory of insider trading.

The misappropriation theory of insider trading abandons the fiduciary-shareholder relationship and instead looks for fraud based on the source of material, nonpublic information. This theory relies on a very broad reading of all of the terms used in Section 10(b) and Rule 10b-5. The theory thus applies to persons who have no ties to corporate insiders. Moreover, the theory has an unidentifiable scope of application because of the inability to categorize all fiduciary and fiduciary-like duties that may exist.

Thus, while the misappropriation theory is designed to achieve the underlying purpose of securities regulation, namely, promotion of investors' expectations of fairness and equal opportunity, it does so in an inequitable manner. Inequity arises because the theory focuses on

233. 463 U.S. 646 (1983).

the status of the communicator of the material, nonpublic information, rather than on the status of the information communicated. This inequity allows one party to use information for their benefit in a securities transaction, while another party may not use the exact same information unless they first disclose the superior information possessed. Both situations equally implicate the underlying goals of fairness and equal opportunity; it does not make sense that different outcomes should result.

A new rule promulgated under Section 10(b), one that focuses on the status of information used in a securities transaction, will alleviate many of the problems currently existing in insider trading regulation. This additional rule should focus on the status of the information used in a securities transaction and not on the presence of a fiduciary or fiduciary-like duty. This type of rule will adhere more closely to the underlying tenets of securities regulation, and will cover investment in debt instruments, an area not regulated under the current structure. While promulgation of a new rule will initially add to the morass that exists in the regulation of insider trading, the proposed rules are straightforward, and an adoption of any one of them will quickly alleviate many of the inequities that currently exist in the securities markets.