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RISK ARBITRAGE AND INSIDER TRADING: A FUNCTIONAL ANALYSIS OF THE FIDUCIARY CONCEPT UNDER RULE 10b-5

INTRODUCTION

On November 14, 1986, the Securities and Exchange Commission (SEC) announced that a leading risk arbitrageur,¹ Ivan F. Boesky, had consented to an injunction² entered in Federal District Court, barring him from trading securities. The announcement stunned both professional traders and the investing public.³ At the same time the announcement was made, subpoenas were served on several other prominent Wall Street figures by the United States Attorney for the Southern District of New York, causing widespread concern in the capital markets.⁴ Within two days of the announcement of Boesky's

1. See Boesky, *The Risk Arbitrageur: Growing Presence Abroad*, 20 MERG. & ACQ. 82 (1986). "Risk arbitrage was born of corporate reorganization or merger activity." *Id.* Risk arbitrage is commonly associated with the trading of stock after a takeover bid has been made public. Arbitrageurs, however, also trade prior to announcements (anticipatory arbitrage), and participate in a wide spectrum of non-takeover situations including liquidations and reorganizations; see also Phalon, *Tipping the Takeover Balance of Power*, 16 MERG. & ACQ. 52-56 (1982).

2. Securities and Exchange Comm'n v. Boesky, Fed. Sec. L. Rep. (C.C.H.) ¶ 92,991 (Nov. 14, 1986). Without admitting or denying the allegations of the SEC complaint, Boesky consented to the entry of a final judgment of permanent injunction and other equitable relief permanently enjoining him from future violations of Sections 10(b) and 14(e) of the Exchange Act. Boesky also paid the equivalent of \$100 million in cash and assets, \$50 million of which represented a civil penalty to be paid to the Treasury of the United States under the Insider Trading Sanctions Act, 15 U.S.C. § 78(d)(2)(A). The Boesky complaint alleged that Boesky had obtained material nonpublic information about future transactions from investment banker Dennis B. Levine. Boesky knew or had reason to know that the information was confidential and had been obtained through misappropriation or a breach of a fiduciary duty or other relationship of trust and confidence. Boesky allegedly made a number of deals on the basis of this information and allegedly agreed to pay Levine five percent of the profits accruing to the entities under his [Boesky's] control in those instances where the material nonpublic information provided to Boesky by Levine was the basis for the purchase of securities by the entities under Boesky's control. Levine allegedly disclosed information to Boesky concerning material nonpublic information concerning a possible merger of Nabisco Brands, Inc. and R. J. Reynolds, a possible tender offer for Houston Natural Gas Corp. by InterNorth, Inc. and a contemplated recapitalization of FMC Corporation. Boesky, utilizing this information, allegedly netted approximately \$4 million, \$4.1 million, and \$975 thousand.

3. See Kilborn, *Big Trader to Pay U.S. \$100 million for Insider Trading Abuses*, N.Y. Times, Nov. 15, 1986, at A1, col. 6.

4. See Stewart & Hertzberg, *Fall of Ivan Boesky Leads to Broader Probe of Insider Information*, Wall St. J., Nov. 17, 1986, at A1, col. 6.

prior insider trading, the Dow Jones industrial average dropped 56 points.⁵

Prior to the public announcement of Boesky's settlement of insider trading charges, the SEC allowed Boesky to liquidate large stock holdings to reduce the margin debt of certain investment securities he managed.⁶ Wall Street traders were incensed: "[H]aving hoodwinked other investors by using nonpublic information to make \$50 million in profits [Boesky] took advantage of the market one last time by trading on the basis of his pending settlement with the government."⁷ Wall Street's reaction was not uniformly supportive of the SEC's efforts in stopping Boesky.⁸ A one-day drop in the market, for example, prompted an editorial in the Wall Street Journal which implied the public would be better served if government investigations were ended.⁹ In general, though, there was a perception that inside trading by large traders on Wall Street was so widespread as to require changes in the laws prohibiting insider trading.¹⁰

While the vast majority of commentators agree that trading on inside information is detrimental to the market,¹¹ some have recently

5. See Vartan, *Cloud Over Takeover Stocks*, N.Y. Times, Nov. 20, 1986, at D1, col. 3.

6. See Nash, *S.E.C. is Under Fire in Letting Boesky Sell Off Holdings*, N.Y. Times, Nov. 21, 1986, at A1, col. 1.

7. *Id.* at D6, col. 4. Wall Street traders, however, were not the only ones upset by Boesky's settlement. An article published in the Wall Street Journal later suggested that the Securities and Exchange Commission "appears likely to realize only \$87 million of the \$100 million it expected from Ivan F. Boesky to settle civil insider-trading charges."; Stewart, *Boesky Pact May Give SEC \$13 Million Less Than Believed, Court Files Indicate*, Wall St. J., July 2, 1987, at 3, col. 3. Apparently "Mr. Boesky's stock in a British investment company—Cambrian & General Securities PLC—previously believed to be valued at more than \$50 million, may be sold for only \$37 million." *Id.*

8. *SEC v. ?*, Wall St. J., Nov. 20, 1986, at 34, col. 1; see also Bleiberg, *Those Hobnailled Boots*, Barron's, June 2, 1986, at 2 ("[T]he agency [SEC] has been seeking some pretext to impose on Wall Street its twisted views on insider trading."). For a discussion of articles and comments critical of the SEC's actions taken against inside traders, see Daugherty, *Insider Trading Charges Controversial*, N.Y.L.J., Dec. 8, 1986, at 33, col. 4.

9. *SEC v. ?*, Wall St. J., Nov. 20, 1986, at 34, col. 2.

10. This perception was further justified when three members of Wall Street's most respected investment banking houses were handcuffed and arrested for insider trading in Feb. 1986. See Nash, *Three Leading Brokers Seized on Charges of Insider Trading*, N.Y. Times, Feb. 13, 1987, at A1, col. 5.

11. See, e.g., Comments of Arthur Levitt, Jr., Chairman of the American Stock Exchange, quoted in *Business Week*, Apr. 29, 1985, at 79 ("If the investor thinks he's not getting a fair share, he's not going to invest and that is going to hurt capital formation in the long run."); A.B.A. COMM'N. ON FEDERAL REGULATION OF SECURITIES, *Report of the Task Force on Regulation of Insider Trading-Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934*, reprinted in 41 BUS. LAW 223, 227-28 (1985) [hereinafter *Report*] ("[B]oth authoritative commentators and common sense tell us that if investors do not anticipate fair treatment, they will avoid investing in securities. As a result, capital formation through securities offerings will become less attractive."); Brudney, *Insiders, Outsiders and*

questioned whether the securities laws reach the activities of non-insider, risk arbitrageurs like Ivan Boesky, who allegedly owe no fiduciary duty to those harmed by their use of nonpublic information.¹² An attempt to find liability for insider trading in a Boesky-type case might be thought to involve improper extensions of existing securities law. First, violations of Rule 10b-5,¹³ the primary provision under which insider trading violations have been prosecuted, require that the accused breach a fiduciary duty to the party injured.¹⁴ The leading case construing Rule 10b-5, *Chiarella v. United States*,¹⁵ looked to the traditional common law categories of fiduciaries to determine whether a particular trader was a fiduciary. Since risk arbitrageurs have never been held to be fiduciaries, there is some question under *Chiarella's* common law analysis as to whether a trader like Boesky could have breached the requisite duty. Under existing case law, a breach of fiduciary duty is a necessary condition for finding insider trading liability under Rule 10b-5. In addition, it has been argued that the misappropriation theory,¹⁶ currently the law in

Informational Advantages Under the Federal Securities Laws, 93 HARV. L. REV. 322, 355-57 (1979) (insider trading decreases the flow of investment capital into an "unfair" marketplace increasing the inside trader's incentive to manipulate the market through the withholding of material, nonpublic information). But see H. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1966). Manne takes the position that the use of inside information increases the efficiency of the market by disseminating accurate information quickly and efficiently. In response to Manne, see Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425, 1448-57 (1967); see also Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1225-45 (1981).

12. See Arkin, *Reflections on 10b-5, 14e-3, 13-D in light of the Boesky Affair*, N.Y.L.J., Nov. 26, 1986, at 3, col. 1.

13. Rule 10b-5, 17 C.F.R. § 240.10-5 (1982).

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

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

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

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

Id.

14. See Arkin, *supra* note 12, at 3, col. 1; Rakoff, *The Great 10b-5 Wars*, N.Y.L.J., Jan. 8, 1987, at 2, col. 1-4.

15. 445 U.S. 222 (1980).

16. Under the misappropriation theory, a person who buys or sells securities on the basis of material nonpublic information that has been misappropriated from another person is guilty of a violation of Rule 10b-5. See Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 114 (1984).

the Second Circuit and recently affirmed in a four-four decision in the Supreme Court,¹⁷ improperly broadens liability under the securities laws.¹⁸ It has also been suggested that since the misappropriation theory provides no private right of action for violations under Rule 10b-5, finding Rule 10b-5 liability under that theory in a Boesky-type case would not be particularly helpful to those investors injured by an improper use of nonpublic information.¹⁹

Part I of this note examines the policy considerations underlying Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by the SEC and argues that the question of who has a fiduciary duty cannot be answered by looking solely to the traditional categories of individuals previously determined by case law to have such duties. In fact, current case law fails to articulate any detailed analysis of the general term fiduciary or any functional analysis of the concept fiduciary which provides adequate guidance to a court faced with the question of determining whether a fiduciary duty should be imposed on particular investor or a new class of investors.

This note contends that if the concept of fiduciary duty is to continue to provide a necessary condition for the imposition of Rule 10b-5 liability, as *Chiarella* requires, the policies supporting and ultimately justifying the rule itself must be used to formulate a concept of fiduciary duty for purposes of the imposition of Rule 10b-5 liability. This explication need not be in the form of a definition of the term fiduciary or a statement of necessary conditions for imposition of the duties of a fiduciary. Rather, it is suggested that the function of the fiduciary concept within the context of Section 10(b) and Rule 10b-5 can provide sufficient guidance to courts to render a reasoned judgment as to who should be fiduciaries for purposes of liability under the Rule. It is argued that a functional analysis of the fiduciary concept under Rule 10b-5 mandates the conclusion that risk arbitrageurs like Ivan Boesky owe fiduciary duties to the market itself and derivatively to each investor in the market. Such duties are owed because of the tremendous impact which risk arbitrageurs have on the market.²⁰

17. See *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

18. See Arkin, *Insider Trading—Distinguishing Unequal Advantage From Fraud*, N.Y.L.J., June 19, 1986, at 4, col. 1; Rakoff, *supra* note 14, at 2, col. 3-4.

19. See Arkin, *supra* note 18, at 4, col. 2-3.

20. See Phalon, *supra* note 1. Phalon noted that arbitrageurs on the street numbered probably no more than about 25, and described the "massive buying power" of the arbs, and the fact that they are "cloaked in fearsome power." *Id.* at 52. It is this massive buying power,

Part II suggests that consideration of market impact provides a better criterion for determining which individuals are fiduciaries in the Rule 10(b)-5 context than rigid application of common law categories. The theory that market impact should be a crucial feature determining the content of the concepts of duty and reliance is discussed in the context of the so-called fraud-on-the-market cases. The fraud-on-the-market cases provide precedent for the functional analysis of the fiduciary concept advocated in Part I. The analysis contained in this line of cases justifies the modification of the traditional common law concept of reliance in the Rule 10b-5 context and generates a new concept of reliance appropriate to that context in order to realize the goals of the securities laws.

This is precisely what Part I asserts must be done in order for the concept of fiduciary to play an effective role in Rule 10b-5 analysis. Though the limited and categorical fiduciary duty analysis provided by *Chiarella* is rejected in Part I, Part II argues that finding a fiduciary duty in a certain restricted class of investors who have a tremendous impact on the market itself is consistent with *Chiarella's* holding that no general duty exists among all participants within the market,²¹ and is based on the principle that the risk arbitrageur is, in the language of *Chiarella*, anything but a stranger to either corporations or sellers in the market.²² The fraud-on-the-market theory, like the market impact theory, emphasizes both the relevance of the effects of an investor's actions on the market itself and the evolutionary nature of concepts entwined with Rule 10b-5 analysis. This market impact theory of liability under Rule 10b-5 is conservative in retaining the fiduciary framework adopted by the Court in *Chiarella*, but offers an analysis of the fiduciary concept missing in both *Chiarella* and existing case law. It is also conservative in making the market the focus of inquiry rather than other types of rela-

often generated with borrowed capital, which allows arbitrageurs to often determine "what the market price is going to be and into whose hands the target will fall." *Id.* at 53. In a number of situations, a single arbitrageur, "Ivan Boesky, emerged as such a large shareholder . . . he was able to call the tune almost on his own." *Id.* at 55; see also Dennis, *Risk Arbitrageurs and the Market for Corporate Control*, 37 HASTINGS L.J. 409, 421 (1985) ("Returns in excess of sixty percent on an annualized basis are not uncommon . . . arbitrageurs now account for such a significant fraction of the trading in partial and two-tiered offers, their judgments are quickly communicated to the market."); Ehrbar, *How to Play the Arbitrage Game*, FORTUNE, July 1976, at 83-86 (arbitrageur profits immense when computed at annual rates); *Arbitrage: It's the Hottest Game in Town*, BUS. WK., Jan. 17, 1977, at 71 (potential profit in risk arbitrage is enormous); Bruck, *My Master is My Purse*, ATL. MO., Dec. 1984, at 94 (extensive profile of Boesky and detailed description of risk arbitrage).

21. 445 U.S. 222, 233 (1980).

22. *Id.*

tionships. Finally, the market impact theory as developed in this note, does not mandate that an equivalent amount of investment information be available to all investors.

Part III discusses the misappropriation theory as it has developed in the Second Circuit and compares its analytical framework to both the historical/categorical fiduciary analysis adopted by the Supreme Court in *Chiarella*, and the more flexible market impact theory developed in this note. Part III argues that significant theoretical difficulties exist in the framework provided by the misappropriation theory which make its application to the Rule 10b-5 context problematic. In particular, it is argued that the misappropriation theory is misfocused on the employer-employee context, is inconsistent with existing case law, and that the failure of the Second Circuit to find a private right of action under the misappropriation theory²³ undermines the broad remedial and deterrent policies of Rule 10b-5.²⁴

Part IV proposes a set of standards which, if legislatively or judicially adopted, would render determinate the concept of *significant* impact in the application of the market impact theory. By specifying the level of impact necessary to create a fiduciary duty in an investor, the market impact theory provides adequate notice to investors as to when the impact of their trading on the market becomes so substantial that they will be held to have a higher level of duty than the ordinary investor. The practice of stock warehousing is then discussed.²⁵ A brief discussion of the effects an application of a market impact theory would have on the use of nonpublic information by risk arbitrageurs and institutional traders follows. The market impact theory would allow the possibility of finding liability under Rule 10b-5 in *all* instances where investors' trading *significantly* impacts on the market regardless of the presence of common law fiduciary duties. Under existing theories of Rule 10b-5 jurisprudence, no such liability exists.

The inadequacy of Rule 14e-3²⁶ as a constraint on the use of nonpublic information by risk arbitrageurs and institutional traders is then discussed. This note argues that even if Rule 14e-3 precludes pre-tender offer stock accumulation by risk arbitrageurs and institutional traders, and even if the SEC has not exceeded its authority in promulgating Rule 14e-3, restriction of Rule 14e-3 to tender offer

23. See *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 15-16 (2d Cir. 1983).

24. See *infra* notes 26-38 and accompanying text.

25. See *infra* notes 271-88 and accompanying text.

26. 17 C.F.R. § 240, 14e-3 (1980); see *infra* notes 280-88 and accompanying text.

context allows the exploitation of nonpublic information by large traders in all other market transactions. As such, Rule 14e-3 is inadequate as a means of fostering the fairness and integrity of the market which the securities laws have attempted to realize.

Finally, the proposed Insider Trading Proscriptions Act (the Act)²⁷ is examined. Had the Act been passed, it would have constituted an improvement in terms of clarity over existing case law, but it would not have found liability in that small class of traders who, as a matter of course, use nonpublic information to the disadvantage of every investor with whom they trade, while reaping staggering profits. Though touted as a solution to the problem of insider trading, the Act would have simply perpetuated the same loopholes which have allowed a few wealthy and powerful traders and institutions to exploit small investors. In this regard, it is typical of approaches which refuse to make market impact the ultimate point of analysis.

This note concludes that until the exploitation of nonpublic information by risk arbitrageurs and large institutional traders is recognized and treated as a violation of the securities laws, the hope of the drafters of those laws, to create a fair and honest market in which investors could and should have confidence, will be left unrealized.

PART I

The securities law restrictions on insider trading derive from Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act). The stated purpose of the Exchange Act is "the maintenance of fair and honest markets in such [securities] transactions."²⁸ This purpose was recorded in the House Report prepared at the time the legislation was passed:

The causes of dangerous speculation in the securities markets go far deeper than defects and abuses in stock-exchange machinery alone. . . . They include inadequate corporate reporting which keeps in ignorance of necessary factors for intelligent judgment of the values of securities a public continually solicited to buy such securities by the sheer advertising value of listing. They include management in possession of inside information. Speculation, manipulation, faulty credit control, investors' ignorance, and disregard of trust relationships *by those whom the law should regard as fiduciaries*, are all a single

27. S. 1380, 100th Cong., 1st Sess., 133 CONG. REC. 247-48 (1987).

28. Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1982)).

seamless web. No one of these evils can be isolated for cure of itself alone.²⁹

Two aspects of this statement have been found particularly noteworthy by commentators.³⁰ First, the text states there are persons whom the law *should* regard as fiduciaries.³¹ Second, the Report's reference to a "seamless web" suggests that the sections of the 1934 Act should not be analyzed separately, but rather as complementary parts of a comprehensive effort to reform stock trading.

While it is logically possible that all persons who should be regarded as fiduciaries currently are regarded as fiduciaries, this statement is not supported by either the broad remedial purposes of the Act itself or a number of explicit statements contained in the Act's legislative history.

As to the propriety of expanding the categories of those whom the law should regard as a fiduciary, the House Report stressed the need for a constant extension of the legal conception of a fiduciary relation. In particular, Congressman Sam Rayburn of the Committee on Interstate and Foreign Commerce wrote:

Unless constant extension of the legal conception for a fiduciary relationship—a guarantee of "straight-shooting"—supports the constant extension of mutual confidence which is the foundation of a maturing and complicated economic system, easy liquidity of the resources in which wealth is invested is a danger rather than a prop to the stability of that system Just in proportion as it becomes more liquid and complicated, an economic system must become more moderate, more honest, and more justifiably self-trusting.³²

29. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 3, 5 (1934) (emphasis added).

30. See Seligman, *The Reformulation of the Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1109 (1985).

31. *Id.*

32. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 3, 5 (1934). Though the cited passage received no direct explication in the record, an analysis of the role of the fiduciary concept as "one thread in the net thrown up by the common law for the protection of business structures" was incisively discussed in Weinrib, *The Fiduciary Obligation*, 25 U. TORONTO L.J. 1, 11, 15 (1975) ("In the course of protecting the plaintiff's organization, the fiduciary concept simultaneously performs the subordinate function of maintaining the integrity of the marketplace in which the organization operates."). Weinrib continued:

[T]he subordinate motive of preserving fair competition among the investors in the corporate market has taken on a life of its own. The quibble over nomenclature—whether an insider in this context can be labelled as a fiduciary—is not important. But it is important to realize that the *insider-trading cases mark the beginning of a substantially new conceptual direction for the fiduciary relation*. This is new wine which is being poured into old bottles (emphasis added).

Id. at 15 (citation omitted); Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA REV. 738 (1978); see also Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 6 (1982) ("The func-

The two passages quoted above support the proposition that there are or may become new individuals whom the securities laws *should* regard as fiduciaries. Because the extension of the legal conception of "fiduciary relationship" was perceived as a vehicle for guaranteeing "straight-shooting" in a maturing and increasingly complicated market and a "prop" to that system, a clear understanding of the role of the fiduciary concept within the securities context, and in particular the insider trading context, is crucial. Congressman Rayburn was clear in describing those individuals who would be fiduciaries under an extended concept of fiduciary relationship. In the paragraph directly following the abovementioned text, he quoted President Wilson:

Society cannot afford to have individuals wield the power of thousands without personal responsibility. It cannot afford to let its strongest men be the only men who are inaccessible to the law. Modern democratic society, in particular, cannot afford to constitute its economic undertakings upon the monarchical or aristocratic principle and adopt the fiction that the kings and great men thus set up can do no wrong which will make them personally amenable to the law which restrains smaller men; that their kingdom, not themselves, must suffer for their blindness, their follies, and their transgressions of right.³³

Of the many concerns of the securities laws which have been widely discussed,³⁴ the restoration of public confidence in a fair market has been a central theme in the literature of insider trading.³⁵

tional justification for imposing fiduciary obligations is based on the idea of 'agency costs.' Socially desirable relationships will be facilitated by general rules governing the fiduciary's behavior, by reducing the need for contractual restrictions on the fiduciary's discretion.").

33. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 3, 5 (1934) (Sam Rayburn quoting President Wilson).

34. Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1311 (1981). Professor Barry has stated that while the prevention of fraud and overreaching and the loss of public confidence in the securities markets believed to accompany such practices have been a principal concern of the securities laws, "[o]f equal importance . . . has been the desire to ensure efficient capital markets and to encourage entrepreneurial market research" (citation omitted). For a clear discussion of how risk arbitrage helps make the market inefficient, see Turner, *Should Tender Offer Arbitrage be Regulated?* 1978 DUKE L.J. 1000, 1023-25; see also *infra*, notes 80-81 for a brief discussion of Turner's view. A view contrary to Turner's is contained in Dennis, *Risk Arbitrageurs and the Market for Corporate Control* (Book Review), 37 HASTINGS L.J. 409 (1985).

35. See, e.g., Seligman, *supra* note 30, at 1104.

The Exchange Act was enacted by Congress in order to regulate the relationship of the investing public to corporations which invite public investment. Its preamble announces that the purpose of the Act is 'to prevent inequitable and unfair practices' in securities transactions generally. One of its primary objectives was to restore and maintain investor confidence in capital markets of the United States. The impairment of investor confidence caused by the misuse of information available to only a privileged few was rec-

The need for some form of increased regulation of the market has become increasingly apparent given the general perception that trading on inside information is increasing.³⁶ This perception has been strongly reinforced by the involvement of several of Wall Street's most prominent institutions and figures in the wake of the Boesky scandal.³⁷

Despite concerns that inequality in the position of different classes of traders has been growing, the market has increasingly become, in the words of one commentator, "bifurcated into one class of investors with a material information advantage and a second, larger class of uninformed public investors."³⁸ Given this unequal access to infor-

ognized by Congress in enacting the Exchange Act. (Quoting Faberge, Inc., 45 S.E.C. 249, 254 (1973)).

See also Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 334 (1979) (candor essential to restoring trust in the market); Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 848 (1973) [hereinafter *Fleischer*] (market specialist given "informational advantages so that he may 'assist in the maintenance, so far as practicable, of a fair and orderly market'") (quoting 1934 Act Rule 11b-1(a)(2)(ii)). For the Supreme Court's most recent reaffirmation of this principle, see *Basic Inc. v. Levinson*, 108 S. Ct. 978 (1988), discussed *infra* notes 126-36 and accompanying text.

36. Seligman, *supra* note 30, at 1087 n.23.

It is generally believed that the amount of trading on nonpublic information has been increasing. The House Report accompanying the 1984 Insider Trading Sanction Act attributed this increase to the growth in the number of mergers and tender offers and the growth of the option markets 'where a small investment in options can yield enormous profits if the underlying stock increases in value as a result of the tender offer announcement or other news.' H.R. REP. NO. 355, 98th Cong., 1st Sess. 5, reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2274, 2278.

Id.

The result of a recent analysis of 172 successful tender offers (from 1981 to 1985) provides further support for this conclusion. In every single instance, the price of target company stock began to rise abnormally roughly 17 days prior to announcement of the offer. While approximately one-third of the pre-bid stock appreciation was attributed to foothold acquisitions by the bidder, the report was "unable to explain a great deal to the pre-bid trading." See *Stock Trading Before the Announcement of Tender Offers: Insider Trading or Market Anticipation?*, Study by the Office of the Chief Economist-Securities and Exchange Commission, Feb. 24, 1987; see also Keown and Pinkerton, *Merger Announcements and Insider Trading Activity: An Empirical Investigation*, J. FIN. 855-69 (1981).

37. See Prokesch, *Arbitrageurs Worried By Arrests*, N.Y. Times, Feb. 13, 1987, at D1, col. 1; see also, Nash, *Three Leading Brokers Seized on Charges of Insider Trading*, N.Y. Times, Feb. 13, 1987, at A1, col. 4.

38. Seligman, *supra* note 30, at 1129. As stated in the introduction to this note, a parity of information theory is not advocated nor is it a necessary element of the market impact theory. A parity of information theory generally asserts that all investors are entitled to equal or roughly equal information in making their investment decisions. This theory was rejected in *Chiarella*, 445 U.S. 222 (1980) and *Dirks v. SEC*, 463 U.S. 646, 657-58 (1983) ("[a] duty [to disclose] arises from the relationship between parties and not merely from one's ability to acquire information because of his position in the market."). This note argues that tremendous differences in access to information can be a factor in an individual trader's ability to signifi-

mation which currently exists, a clear understanding of the duties of those who have institutionally guaranteed advantages over other investors is called for,³⁹ especially since access to inside information creates so powerful a temptation to use that information to one's own advantage.⁴⁰

Prior to *Chiarella v. United States*, which was decided in 1980, the case law construing Rule 10b-5 clearly reflected an awareness of the policies of fairness underlying the Rule.⁴¹ The early case law

cantly impact on the value of shares in the market. To the extent that a trader's influence on the market is "significant," as defined in Part IV of this note, see notes 249-60 and accompanying text, it is argued that the trader should be treated as a fiduciary for purposes of imposition of Rule 10b-5 liability where he trades on the basis of nonpublic information to the detriment of other traders in the market.

39. The institutionally guaranteed advantages of risk arbitrageurs not only consist in access to the best available research legitimately available and a cost structure which the ordinary investor cannot hope to duplicate, Phalon, *supra* note 1, but also in the gray area of easy access to nonpublic information based on the fact that arbitrageurs join with other members of the financial community in takeover activities implicating enormous monetary investments. The arbitrageur has become increasingly involved in worldwide finance. Ivan Boesky has stated, speaking of arbitrageurs generally, "We are engaged right now in substantial refunding around the world for the purpose of being able to take advantage of what is now a much greater universe than has ever been the case in the history of mergers and acquisitions in America." *The Risk Arbitrageur: Growing Presence Abroad—Conference Presentation by Ivan Boesky*, First Annual Conference on International Mergers and Acquisitions, Oct. 29-31 (1986), 20 MERG. & ACQ. 82, 83 (Mar.-Apr. 1986); see also SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, REPORT ON THE TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987, S. REP. NO. 265, 100th Cong., 1st Sess., 23 (1987):

[D]uring the last several years bidders have evaded the spirit of the law with respect to disclosure of the complete identity of those engaged in a takeover bid. Modern pools, composed of investment bankers, institutions, arbitrageurs and others who join an acquiror in takeover activities, increase the potential for market manipulation. These entities represent potent allies to an acquiror.

Id.

40. The recent willingness of investment banking firms to commit substantial amounts of their own capital to facilitate and ensure success of client acquisitions, (see Madden, *Investment Banks Adopt New Role With Bridge Financing*, N.Y.L.J., Mar. 16, 1986, at 29, col. 1), and the fact that the buy side of the market consists almost solely of arbitrageurs, see Rubin, *Arbitrage*, 32 BUS. LAW 1315, 1315 (1977)), makes arbitrageurs' exploitation of their position extraordinarily tempting. Given that arbitrageurs are by some estimates involved in roughly seventy percent of the deals on the street, (see Comments of Robert Millard, Executive Vice President of Shearson Lehman Brothers, *The Place of Arbitrageurs in Mergers and Acquisitions*, 21 MERG. & ACQ., 24, 37 July-Aug. (1986)), and that by the time a deal involving a relatively small company comes to a close as much as fifty percent of that company is owned by arbitrageurs, (see Comments by Sheila Cunningham, Vice President of Paribas Corp., at 36), the close involvement of parties with nonpublic information, and the staggering sums of money involved, go a long way in explaining the present scandal on Wall Street. See BUS. WK., Jan. 12, 1987, at 110. (The total securities industry's capital has grown from 8 billion dollars to 35 billion dollars over the past five years and more than 60 percent of the industry's capital is currently held by 10 firms controlling similar portions of industry revenues.).

41. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) (disclose or abstain rule based on justifiable expecta-

concentrated on the fiduciary duties owed by traditional corporate insiders such as directors and officers.⁴² There was no reason, however, to expect the policy considerations justifying the imposition of Section 10(b) liability in the context of traditional fiduciary relationships to constrain application of insider trading liability to only these categories of investors.⁴³ By the early 1960's, an expansion of insider trading liability was underway which began looking to considerations other than the traditional categories of common law fiduciaries as indicators of which individuals could be liable under Rule 10b-5.

In the Matter of Cady, Roberts & Co.,⁴⁴ questioned whether a broker, having received nonpublic information as to a company's dividend action from his father who was a director, could trade without disclosing that information prior to trading. Noting that the anti-fraud provisions of the securities laws were phrased in terms of "any person"⁴⁵ and that "a special obligation" had been traditionally required of corporate insiders, e.g., officers, directors and controlling shareholders, the Commission stated:

These three groups, [officer(s), directors and controlling shareholders], however, do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in

tion of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951) (duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders).

42. See, e.g., *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951); *Kardon v. National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa. 1947). *Chiarella* was very much in this tradition. See A. BROMBERG & L. LOWENFELS, 3 SECURITIES FRAUD & COMMODITIES FRAUD § 321 (1984) ("In *Chiarella* . . . the Court seems to contemplate mainly a fiduciary relationship arising from position with issuer of the securities: director, officer or employee These positions are traditionally regarded as fiduciary by the common and corporate law on which the Court relies so heavily.").

43. See *supra* notes 28-33 and accompanying text.

44. 40 S.E.C. 907 (1961).

45. Rule 10b-5, 17 C.F.R. § 240, 10-5 (1982).

trading in its securities. Intimacy demands restraint lest the uninformed be exploited.⁴⁶

Even those theorists who deny that analysis of Rule 10b-5 should be, or currently is, conducted with a primary focus on fairness, equity and rough informational equality have recognized that analysis of Rule 10b-5 in the courts was initially so conducted.⁴⁷ In fact, given that there is no generally accepted definition of insider,⁴⁸ insider trading,⁴⁹ or fiduciary duty,⁵⁰ the rejection of rigid classifications and fine distinctions in favor of an analysis of the actual relationship between the parties and the market in order to determine

46. *Cady*, 40 S.E.C. at 912.

47. See, e.g., Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 18 SEC. L. REV. 177, 181-87 (1986). For a discussion of the parity of information theory, see *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968) ("Whether predicated on traditional fiduciary concepts . . . or on the 'special facts' doctrine . . . the Rule [10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."); see also *supra* note 38 and accompanying text.

48. See 5A A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10b-5* § 66.02, at 3-451 to 3-454 (2d ed. rev. 1988). Jacobs catalogues a partial list of the sorts of persons and entities courts have held could be insiders. This list includes accountants, agents for an insider, allies of insiders in tender offers, bankers and lenders, banks selling a loan participation, business associates, competitors, controlling shareholders, corporate trustees, directors, employees of the issuer, engineering advisors, escrow agents, family members, finders, institutional investors, investment bankers, the issuer, lawyers, management consultants, marketing advisors, market makers, merger and acquisition partners, officers, persons contracting with the company, press, wire and other communications personnel, principal stockholders, printers, public relations advisors, registrar or transfer agents, security analysts advising on a merger, stock exchange, SEC, and other regulatory personnel, testing laboratories, underwriters and writers of newspaper articles who recommend purchases of corporation's stock. *Id.* at 3-473 to 3-478. Given the number of diverse persons and entities deemed insiders, this note argues on logical grounds that there can be no clear definition of "insider." The term "insider", much like the term "fiduciary," simply covers too many different relations to have a single, monolithic definition. See *infra* notes 56-60 and accompanying text.

49. See *Insider Trading Sanction and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcommittee on Telecommunications, Consumer Protection and Finance*, 98th Cong., 1st Sess. 1 (1983) (Senator D'Amato of New York discussing the definition of insider trading), cited in Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 17 SEC. L. REV. 187, 191 (1985). The Commission stated, that "[t]he flexibility which is gained by basing the imposition of the penalty on existing case law avoids the problems of freezing into law either a definition which is too broad, or too narrow to deal with emerging issues." The House Committee on Energy and Commerce reported on the bill in H.R. No. 355, 98th Cong., 1st Sess. (1983), cited in Langevoort *supra* at 200-201; see also Junewicz, *Insider Trading Act Is Needed, but Without Defining the Term*, NAT'L L.J., Apr. 30, 1984, at 24, col. 3.

50. See Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 886 (1976) ("The very definition of a fiduciary is nebulous and uncertain; the meaning of the concept of fiduciary responsibility is likewise imprecise and unsure."); Langevoort, *supra* note 32, at 21 n.78. ("The term 'fiduciary' is not subject to precise definition . . .").

appropriate duties is a sensible way to analyze insider trading liability.

These definitional deficiencies are evident in *Chiarella*, which, more clearly than any other case to date, asserted the necessity of finding a fiduciary duty as a necessary condition for the imposition of Rule 10b-5 liability.⁵¹ *Chiarella*, however, failed to provide a cogent analysis of the crucial terms fiduciary and fiduciary duty.⁵² Though this failure was unfortunate for future analytical purposes, it should not have been unexpected. While judicial opinions often hold that "specific conduct is or is not required of a particular defendant . . ."⁵³ or is or is not within the realm of fiduciary responsibility,⁵⁴ "there has been little or no effort to define a fiduciary or to describe what a fiduciary is."⁵⁵

Two explanations have been offered as to why the voluminous case law involving application of the fiduciary concept has provided so little analytical clarification. One of these commentators, who rests his analysis on certain ideological theses about capitalist societies, has presented what may be called an "ideological theory":

Examination of the activities of fiduciaries involves, above all, an inquiry into the propriety of profit-making. What is at stake is whether the court should sanction or stigmatize a particular act performed by a businessman in a commercial context. Given the acceptance by the courts of the value inherent in a capitalist social order, at least in a rudimentary sense, and the fear that it may be beyond a judge's competence to supervise the morality of business transactions, judicial diffidence is understandable.⁵⁶

The ideological theory explains a lack of judicial analysis in terms of a set of *a priori* economic and political theses. The accuracy of the theory is difficult to confirm because there is no way to reach back into the minds of countless judges who have applied the fiduciary concept in dispute resolution.⁵⁷

A second explanation suggests that application of the single term fiduciary to such diverse relations as principal-agent, trustee-benefi-

51. See *infra* notes 61-66 and accompanying text.

52. See *infra* note 67 and accompanying text.

53. Kaplan, *supra* note 50, at 886.

54. *Id.*

55. *Id.*

56. Weinrib, *The Fiduciary Obligation*, 25 U. Toronto L.J., 1, 2 (1975).

57. This author's personal view is that ultimate agreement with the ideological theory is likely to trace to one's own ideological agreement with the economic and political assumptions of the theory itself. This note presupposes the correctness of the logical/linguistic theory and analysis of the fiduciary concept is carried on solely with reference to it.

ciary, director-corporation, partner-partnership, employer-employee, etc., is only possible where the applicable definition of the general term is extremely amorphous.⁵⁸ So long as a single term is to apply to so many different relations, a single, precise and coherent analysis of the notions of duty and responsibility in each relationship under the general term fiduciary will be necessarily precluded.⁵⁹ This theory, since it is based on linguistic and logical considerations will be called the logical/linguistic theory.

The logical/linguistic theory provides an explanation as to why courts have not provided a single, unified and coherent theory of fiduciary duty. Such a theory is logically precluded by the range and complexity of situations to which the general term fiduciary will be applied. For this reason, this note does not attempt to define fiduciary or fiduciary duty, but rather, through consideration of the role the fiduciary concept was meant to play in the Section 10(b) context, provides an analysis capable of picking out fiduciaries so as to allow the fiduciary concept to be a prop to the stability of the market and a guarantee of straight-shooting.⁶⁰

Chiarella v. United States,⁶¹ a leading case on Rule 10b-5 liability concerned Chiarella, an employee of a financial printer, who in the course of his business, received documents concerning the announcements of corporate takeover bids. Though the identities of the acquiring and target corporations were concealed by blank spaces or

58. See *supra* note 56 and accompanying text; *infra* notes 59, 133 and accompanying text.

59. See Kaplan, *supra* note 50, at 887. The inability of general terms to be broad enough to cover large numbers of diverse relations and yet simultaneously, sufficiently precise to state either necessary or sufficient conditions for application of the general terms has been analyzed in a number of non-legal contexts, including discussions contained in the writings of the 20th century logician Ludwig Wittgenstein, (see L. WITTGENSTEIN, *PHILOSOPHICAL INVESTIGATIONS*, (G.E.M. Anscombe trans. 3d ed. 1968)), and 19th century psychologist William James, (see W. JAMES, *THE VARIETIES OF RELIGIOUS EXPERIENCE*). Both authors concluded that the use of a single general term to cover a large number of different activities would preclude identification of some essential feature which all activities allegedly "covered" by the general term "possess." Similar observations in a legal context have been made in the jurisprudential writings of Professor H.L.A. Hart:

[T]he assumption that the several instances of the general term must have the same characteristics may be dogmatic. Very often the ordinary, or even the technical, usage of the term is quite 'open' in that it does not *forbid* the extension of the term to cases where only some of the normally concomitant characteristics are present . . . it is always possible to argue with plausibility for and against such extension. What is more important is that, apart from such borderline cases, the several instances of the general term are often linked together in quite different ways from that postulated by the simple form of definition.

H.L.A. HART, *THE CONCEPT OF LAW* 15 (1961) (emphasis added).

60. See *supra* note 32 and accompanying text.

61. 445 U.S. 222 (1980).

false names, Chiarella was able to deduce the actual companies involved. Without disclosing this knowledge, he purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public, realizing a gain of about \$30,000. Chiarella was indicted on seventeen counts of violating Section 10(b) of the Exchange Act and Rule 10b-5. His conviction was affirmed by the Second Circuit,⁶² but the Supreme Court reversed, holding that Chiarella's use of nonpublic information was not fraudulent under Section 10(b) because he was not subject to an affirmative duty to disclose.⁶³ The Court stated:

No duty could arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions. We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.⁶⁴

The Court ultimately held that a duty under Section 10(b) does not arise from the mere possession of nonpublic information,⁶⁵ and noted in dicta that not every instance of financial unfairness constitutes fraudulent activity under Section 10(b).⁶⁶

Under *Chiarella's* analysis, an improper use of material inside information will not be actionable under Rule 10b-5 absent a duty to disclose. An individual has such a duty when he is an agent, a fiduciary, or a person in whom others place trust and confidence. While *Chiarella* is a tremendously important case insofar as it brought to the fore the fiduciary concept as a necessary element in contemporary Rule 10b-5 analysis, it is equally important for what it fails to say.

At no point did the Court articulate the class of circumstances which could generate a fiduciary duty. It did not state conditions necessary to finding that an individual has a fiduciary duty, nor did the Court state why a person is a fiduciary, with or without reference to Rule 10b-5.⁶⁷ The Court, instead, simply identified several tradi-

62. 588 F.2d 1358 (2d Cir. 1978).

63. 445 U.S. 222, 231.

64. *Id.* at 232, 233.

65. *Id.* at 235.

66. *Id.* at 232.

67. If the logical/linguistic theory is correct, it would have been logically impossible for the Court to have done so. *See supra* notes 56-60 and accompanying text.

tional categories of individuals who had been held to have fiduciary duties under then existing case law; found that Chiarella did not fit any of the identified categories; and concluded, on that basis, that Chiarella had no fiduciary duty.

While the fiduciary concept is often described in terms of an "actual expectation of fair dealing arising from a relationship of trust and confidence,"⁶⁸ one commentator has noted that the "trust and confidence" formulation, "while etymologically correct, cannot be regarded as analytically satisfying."⁶⁹ This is because presence of the actual subjective trust on the part of the person to whom the fiduciary owes his duty is irrelevant to whether the party allegedly owing the duty will be deemed a fiduciary.⁷⁰ Rather, in the words of E. J. Weinrib, one of the few commentators who has tried to analyze the fiduciary concept, the term fiduciary is attached to certain "crystallized relations such as principal-agent, director-corporation, partners, employer-employee,"⁷¹ which,

while effective enough as a solvent for cases, is not without its dangers. The existence of a list of nominate relations dulls the mind's sensitivity to the purposes for which the list has evolved and tempts the court to regard the list as exhaustive and to refuse admittance to new relations which have been created as a matter of business exigency Like the categories of negligence, the categories of fiduciary should not be considered closed. Indeed, it would be desirable to go beyond the categories and the labels to an awareness of the purpose for which the categories and the labels have been enshrined.⁷²

Therefore it makes little sense to restrict inquiry as to whom the securities laws *should* regard as fiduciaries by looking to categories of individuals who have in the past, under differing market conditions, been *held to have been fiduciaries*. Rather than the simplistic "trust and confidence" formulation advanced in countless cases, evolving market conditions require a more sophisticated conception of fiduciary.⁷³

68. See Langevoort, *supra* note 32, at 5.

69. Weinrib, *supra* note 56, at 5.

70. *Id.* ("The fact that a beneficiary has subjectively no trust at all in the judgment of the person whom the settlor has installed as trustee does not in any way relieve the trustee of the high standard that equity imposes."). *Id.* at 5.

71. *Id.*

72. *Id.* at 5,7.

73. Langevoort, *supra* note 32 at 5.

The fiduciary principle is often described in terms of an actual expectation of fair dealing arising from a relationship of trust and confidence, but a careful reading of these cases reveals a broader principle. While some of the early cases do involve an actual

Were the issues of liability in a Boesky-type case adjudicated,⁷⁴ any legal analysis under *Chiarella*, would necessarily involve a determination of the factual similarity of the uses of nonpublic information by Boesky and Chiarella. Under a market impact theory, the *consequences* of the use of nonpublic information would be part of a legal analysis, and therefore, the relationship of the insider trader to the market would be a fundamental part of the inquiry. Specifically, in the Boesky case, if Boesky's relationship to the investing public were found to be analogous to Chiarella's relationship to the investing public, then *Chiarella* might be dispositive. But if their respective relationships differed significantly *in kind*, then there might be good reason to believe that the Court's failure to find a fiduciary duty in *Chiarella* would not be dispositive of whether an arbitrageur would be deemed a fiduciary for purposes of imposition of Rule 10b-5 liability.

Recently, commentators have discussed the privileged position of arbitrageurs in the contemporary market. Arbitrageurs trade under circumstances relatively unique in the market⁷⁵ and they currently exert a powerful influence on market transactions.⁷⁶ Further, certain arbitrageurs and

[o]ther major players in the market have cultivated and maintained long standing relationships with principal employees of large investment banking institutions. By virtue of these relationships, it has been suggested that the arbitrageurs were able to obtain a special advantage in the market, in that it is alleged that they may have been provided with advance knowledge of impending takeover attempts.⁷⁷

The position of some market professionals (including arbitrageurs) has been described as follows:

The position which some have on the floor of the exchange, their minute-by-minute knowledge of developments concerning major transactions by significant market actors, their familiarity with plans of their own which may have a market impact, their knowledge of the activities of and constraints operating on other market professionals, their

expectation, recovery has never been limited to instances of misplaced reliance in bargaining.

Id.

74. Since Boesky consented to a judgment and a permanent injunction, the liability issue was never adjudicated. Boesky neither admitted nor denied any of the allegations of the SEC complaint. See Securities and Exch. Comm'n v. Boesky, Fed. Sec. L. Rep. (C.C.H.) ¶ 92,991 (Nov. 14, 1986). For details of some of the allegations set forth by the Securities and Exchange Commission in their complaint, see *supra* note 2.

75. See Arkin, *supra* note 12, at 3, col. 1.

76. See *id.*; see also *supra* notes 20, 37-38 and accompanying text.

77. Arkin, *supra* note 12, at 3, col. 1.

continuous awareness of even public developments before they are disseminated via the media or tape, and their ability instantaneously to execute transactions without paying broker fees, all combine to give these market professionals an incalculable advantage over the average investor.⁷⁸

Another commentator has noted:

[A]rbitrageurs are able to avoid a substantial part of the transaction costs paid by investors and in most cases can rely on ultimately receiving a soliciting dealer's fee. This in effect guarantees arbitrageurs a price higher than that available to investors for tendered stock. Thus, unlike the normal situation where transaction costs have a slight overall impact upon the market, the virtual absence of transaction costs to the arbitrageur allows him to exploit small per-share differentials on a large volume scale in situations where the ordinary investor's profit margin would be entirely absorbed by transaction costs. This one-two punch, consisting of lower costs to acquire target stock, coupled with higher proceeds upon tendering, allows arbitrageurs profitably to bid higher for target stock than investors, contributing to the overpricing of target stock, and, hence, to the inefficiency of the market.⁷⁹

Given the relationship arbitrageurs have with investment banking institutions and corporations, their tremendous informational and financial resources, and their tremendous effect on the value of securities in the hands of other investors,⁸⁰ the trading activities of the

78. Barry, *supra* note 34, at 1381.

79. Turner, *supra* note 34, at 1024.

80. See *supra* notes 20, 32-39. For a detailed discussion of the ways in which tender offer arbitrage affects the value of shares in the market, see Turner, *supra* note 34, at 1005. Turner notes that the effect of arbitrageur purchases is to drive up the price of target stock in the market. Turner argues that the shareholder who is

not involved in arbitraging the transaction . . . must consider the value of the stock as a continuing investment should the tender offer fail, its value as a continuing investment should the shareholder not tender and the offer nevertheless succeed, its value if tendered and accepted, its value if tendered and prorated, and its value on the market. . . . [The arbitrageur] ignores the investment potential of the stock (except as a factor in his initial evaluation of the chances of success for the offer), because he has no intention of becoming an "investor."

Id. at 1023. This "nonhomogeneity of expectations among investors and arbitrageurs necessarily gives rise to inconsistent valuations of target stock by investors and arbitrageurs." *Id.* at 1024. Since the arbitrageur pays virtually no transaction costs, and since "[a]rbitrageurs tend to dominate purchases on the market during pendency of the tender offer." *Id.*

[A]rbitrageur participation implies that the risk itself is diminished, thus allowing for an upward shift in the market for target stock, in many cases to levels in excess of the tender price. This price movement creates an intense pressure on investors to sell into the market without regard for the underlying merits of the tender offer and, hence, to sell into the hands of the arbitrageurs. The arbitrageur can offer a price that investors, who presumably are seeking to avoid risk, simply cannot afford to ignore. Restated in terms of ECMH (Efficient Capital Market Hypothesis) analysis, the investor in an inef-

Boeskys of the market and the trading activities of the Chiarellas of the market are strikingly different.

A simple assertion, therefore, that a trader of Boesky's stature is not a fiduciary because Chiarella is not a fiduciary should be suspect. Boesky, unlike Chiarella, was not a stranger to the purchasers and sellers of stock in the market in any meaningful sense. To the contrary, as one of the wealthiest and most powerful of Wall Street's arbitrageurs, the effects of Boesky's trading on the value of the securities in which he traded and derivatively, on the value of securities in the hands of purchasers and sellers of the stock in which he traded, justify the conclusion that Boesky was anything but a stranger to them. In addition, arbitrageurs are routinely approached by investment bankers and asked to purchase blocks of stock for the purpose of warehousing the stock of target corporations in friendly hands.⁸¹ This warehousing of stock furthers the acquisition goals of acquirers since, by agreement with the arbitrageur, the warehoused stock will be tendered to the offeror at the appropriate time, increasing the chances of a successful transfer of control. Because risk arbitrageurs trade in blocks of shares in the tens of thousands, their impact on the market and the value of stock in the market is quantitatively so much greater than the ordinary investor that it justifies imposition of a qualitatively different sort of duty on arbitrageurs.⁸²

ficient market who is in possession of a stock identified as overpriced has but one rational choice—sell!

Id. at 1024, 1027.

81. See *Chiarella*, 445 U.S. 222, 234 (1980) ("Warehousing takes place when a corporation gives advance notice of its intention to launch a tender offer to institutional investors who then are able to purchase stock in the target company before the tender offer is made public and the price of shares rises."); Welles, *Inside America's Arbitrage Game*, THE INSTITUTIONAL INVESTOR, Aug. 1981, at 223-24; Turner, *supra* note 34, at 1027, 1028 ("arbitrageurs make a market for large blocks of shares held by institutional investors" and "contribute substantially to the successful outcome of tender offers."). A clear discussion of warehousing/stock parking schemes can be found in McLucas, DeTore, *Outline, A Review of Recent SEC Enforcement Actions Against Members of the Securities Industry Involving Parking, Net Capital and Related Violations* (available from the Washington office of the Securities and Exchange Commission). "Warehousing has . . . acquired a specialized meaning in the context of tender offers. A potential offeror is said to 'warehouse' stock by selectively informing institutional purchasers of its interest in a stock This selective disclosure helps to accumulate blocks of the security in the hands of holders disposed to resell." *Id.* at 3, n.1.

82. The justification for imposing a qualitatively different sort of duty on members of a class of investors who significantly affect the rest of the market is found in the purposes of the securities laws themselves. Since a fiduciary duty is a necessary element of imposition of Rule 10b-5 liability and since the extension of the fiduciary concept is the means by which the securities laws were to function to support or prop up our economic system, those individuals who *should be fiduciaries* must be those whose trading activities constitute a threat to the

Since this tremendous impact on the market is dependent on the use by arbitrageurs of nonpublic information directly provided them for the purpose of helping to realize the acquisition goals of particular companies, and since the arbitrageur's advance, nonpublic knowledge of future market transactions disadvantages all investors with whom he trades,⁸³ the issue of whether risk arbitrageurs should be deemed fiduciaries for purposes of imposition of Rule 10b-5 liability can only be answered by examining the policies underlying the Rule and the function of the fiduciary concept as a means to realize those policies.

The anti-fraud provisions of the federal securities acts were designed to serve a regulatory function.⁸⁴ A principal assumption of the securities laws was that investor perception of fairness and honesty in the markets would be essential in restoring trust in those markets.⁸⁵ A critical question to be answered is whether imposing a duty on a special class of investors whose trading significantly impacts on virtually everyone in the market furthers this end.⁸⁶

The fiduciary relationship is ultimately part of a pervasive policy of the law to protect the integrity of commercial organizations and it simultaneously functions to maintain the integrity of the marketplace.⁸⁷ Not only is this generally true of the fiduciary relationship, but it is particularly true in the securities context where the extension of the fiduciary relationship was identified in the Act's legislative history as a means of propping up the stability of the market and the economy as a whole.⁸⁸

stability of that system. *See supra* notes 29-31 and accompanying text. The legislative history of the Exchange Act described these individuals as those "wielding the power of thousands without personal responsibility." *Id.* Risk arbitrageurs currently have no liability for their use of nonpublic information in anticipatory arbitrage transactions under any existing theory of Rule 10b-5 jurisprudence. Yet their trading activities determine the value of securities in the market and continue to undermine confidence in the market. *See supra* notes 75-79 and accompanying text. *See also infra* notes 252-60 and accompanying text for a functional quantification of the concept "significant impact."

83. *See* Turner, *supra* note 34; *see also supra* notes 20, 38-39, 80-81 and accompanying text.

84. Brudney, *supra* note 35, at 335.

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

86. This note does not suggest that restoring trust in the market was the only goal of the federal securities acts, but it does suggest that this is, was and continues to be a fundamental purpose of the anti-fraud provisions. *See supra* note 85. For the Supreme Court's most recent reaffirmation of this principle, see *Basic Inc. v. Levinson*, 108 S. Ct. 978 (1988), discussed *infra* notes 126-38 and accompanying text.

87. Weinrib, *supra* note 56 at 15; *see supra* note 32 and accompanying text.

88. *See supra* note 32 and accompanying text.

Admittedly, while it is difficult to discern how fiduciary duties are created,⁸⁹ pragmatic considerations must often be invoked.⁹⁰ Practically, if a goal of the securities laws is to protect all investors by making the market fair, the finding of a higher duty through the extension of the concept fiduciary to a new class of investors whose trading activities impact significantly on the market and traders in the market,⁹¹ makes a great deal of sense. Limiting liability under the securities laws to those individuals whose characteristics satisfy historically determined but currently limited categories⁹² is contradicted by the flexibility which the words "constant extension" in the legislative history of the Act suggests.⁹³ Similarly, the observed moral character of the concept fiduciary⁹⁴ suggests that as cultural and market conditions change, generating new types of fraud, overreaching, and unjust enrichment, securities law must evolve, consistent with its express purposes. If the evolution of the fiduciary concept requires that an additional class of individuals be held to a higher standard of behavior, then so much the better for the integrity of the market.

PART II

Though no functional analysis of the fiduciary concept has been articulated in the case law construing Rule 10b-5, just such an analysis has been offered for another important common law concept in the Rule 10b-5 context: reliance. The "fraud-on-the-market theory,"⁹⁵ allows a plaintiff to substitute a presumption of reliance on the integrity of the market in fraud actions based on Rule 10b-5, in place of the actual reliance normally required to find liability in ac-

89. Aldave, *supra* note 16, at 109 ("[p]recisely how a breach by the insider creates the requisite fiduciary duty . . . is unclear").

90. *Id.*

91. *See infra* notes 252-60 and accompanying text for a quantification of the concept "significant impact."

92. Weinrib, *supra* note 56, at 6, 7, 20.

Nor should the analytic process be short-circuited by affixing labels Indeed, it would be desirable to go beyond the categories and the labels to an awareness of the purpose for which the categories and the labels have been enshrined [T]here is no substitute for a realistic weighing of the competing social interests at play.

Id. at 6, 7.

93. *See supra* note 32.

94. *See Langevoort, Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1250 (1983) (the desire to avoid unjust enrichment underlies much of fiduciary law).

95. *See Basic Inc. v. Levinson*, 108 S. Ct. 978 (1988).

tions based on common law fraud.⁹⁶ The relation of this theory to the flood of recent insider trading cases⁹⁷ is that the theory and case law adopting it have developed the idea that a duty to the integrity of the market itself is owed by all investors, regardless of the existence of traditional common law fiduciary duties owed to other entities. Even if no fiduciary relationship exists directly or indirectly between defendant and the damaged party under the fraud-on-the-market theory, reliance on a material misrepresentation or omission will be inferred as to the class of defrauded investors.⁹⁸

Under the fraud-on-the-market theory, a sufficient predicate for imposition of liability under Rule 10b-5 is established by proof of both a purchase of securities and materiality of representation.⁹⁹ The case law applying the fraud-on-the-market theory is important for the market impact theory for at least four reasons. First, the fraud-on-the-market theory allows a traditional common law concept, reliance, to be modified in the context of Rule 10b-5 litigation so as to realize the policy considerations underlying the rule itself. This is precisely what Part I has argued must be done to make the fiduciary concept an effective instrument of Rule 10b-5 jurisprudence. Second, the policy consideration invoked by the fraud-on-the-market theory as justification for the modification of the common law reliance requirement is the integrity of the market. This is the same policy consideration which Part I argues is justification for the extension of the fiduciary concept to risk arbitrageurs under the market impact theory. Third, because the fraud-on-the-market theory presumes reliance when there is a material misrepresentation or omission, it is ultimately concerned with the actual effect material information has

96. See Note, *Fraud On the Market Theory*, 95 HARV. L. REV. 1143, 1144-46 (1982); see also Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435 (1984); Note, *Fraud on the Market: An Emerging Theory of Recovery Under SEC Rule 10b-5*, 50 GEO. WASH. L. REV. 827 (1982).

97. Since 1980, for example, there have been fifty-seven defendants criminally prosecuted for insider trading and related offenses, just in the Southern District of New York. A complete list of defendants and their firms, docket numbers and the status of their cases (including penalties) is reported in N.Y.L.J., Feb. 24, 1987, at 17. Whether these recent prosecutions evidence a fundamental change in the ethics of traders generally is open to question. A study of 1700 American corporate executives conducted in 1961, revealed that most corporate executives did not feel inside trading was immoral. In fact, when asked what they would do if they were given material inside information, 42% responded they would buy securities themselves and predicted that 61% of their peers would buy for themselves. See Baumhart, *How Ethical are Businessmen?*, 39 HARV. BUS. REV. 6, 16 (July-Aug. 1961).

98. See *infra* notes 249-60 and accompanying text.

99. *Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975), *cert. denied*, 429 U.S. 816 (1976).

on the value of securities in the hands of shareholders and the market itself. It allows a Rule 10b-5 violation to be found without requiring actual reliance as required by the common law. Since a significant impact on the market justifies a rebuttable presumption of reliance, the common law requirement of actual reliance is modified for purposes of Rule 10b-5 liability. Finally, the fraud-on-the-market theory creates in the party making the misrepresentation, a duty to the market itself based directly on the impact which the allegedly fraudulent act has had on the market itself. Such a duty is owed under the market impact theory when the effect of an investor's transactions create a significant impact on the market itself.

In *Affiliated Ute Citizens of Utah v. United States*,¹⁰⁰ the Supreme Court relaxed the traditional reliance requirement in an action brought under Section 10(b) of the Exchange Act and Rule 10b-5. In *Affiliated Ute*, plaintiff Indians sold shares in their tribal corporation to a bank which was itself making a market in the Indian corporation's shares at a higher price for sale to outside investors. The bank, which failed to reveal its market-making activities, took advantage of the unsophisticated plaintiffs, who relied on the bank as their agent. The Supreme Court held the bank had breached a duty to disclose the material fact that shares were being resold profitably in another separate market.¹⁰¹ Under the facts of *Affiliated Ute*, which involved a failure to disclose, the Court held that "positive proof of reliance is not a prerequisite to recovery."¹⁰² The Court stated that the fundamental purpose of the Exchange Act and its companion legislative enactments was "to achieve a higher standard of business ethics in the securities industry"¹⁰³ and that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purpose.'"¹⁰⁴

Proof of actual reliance was again attenuated in *Blackie v. Barrack*,¹⁰⁵ where purchasers of Ampex securities who engaged in transactions in the stock of Ampex Corporation brought a class action suit under the securities laws for alleged misrepresentations made by Ampex in annual and interim reports, press releases, and SEC filings

100. 406 U.S. 128 (1972).

101. *Id.* at 152-53.

102. *Id.* at 153.

103. *Id.* at 151 (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)).

104. *Id.* (quoting *Capital Gains Research Bureau*, 375 U.S. at 195).

105. 524 F.2d 891 (9th Cir. 1975).

of Ampex Corporation's financial condition. Because material misrepresentations had been made in connection with Ampex Corporation's actual financial condition, and because those misrepresentations influenced enough trading to affect the market price of Ampex securities, the Ninth Circuit Court of Appeals held that a prima facie case of "causation [with respect to each class member] is adequately established in the impersonal stock exchange context by proof of purchase and the materiality of misrepresentation, without direct proof of reliance."¹⁰⁶

Blackie is important for two principal reasons. First, *Blackie* asserts that the analysis of a traditional common law requirement of an action for fraud, actual reliance, should be different than an analysis of the fraud concept under statute. The court of appeals in *Blackie* stated that "although derived from it, the Rule 10b-5 action is not coterminous with a common law fraud action."¹⁰⁷ Under *Blackie's* analysis, the purposes and policy aims of Rule 10b-5 ultimately produced a new concept of reliance appropriate for that rule itself. Furthermore, *Blackie* makes a material misrepresentation's impact on the market itself the focal point of analysis. While *Chiarella* focused attention on the categorical relationship between specific parties to a transaction, *Blackie* focused inquiry on the extent of the market impact effected by the alleged fraudulent act.

In discussing the issue of duty, the court in *Blackie* stated that "[t]he class members also share an interest in establishing the standard of care required of the various defendants under *White v. Abrams*,¹⁰⁸ flexible duty standard."¹⁰⁹ *White* involved an action for punitive damages and rescission on the basis of alleged material misrepresentations in connection with the sale of promissory notes and shares of stock. Analyzing the concept of duty under Rule 10b-5, the *White* Court stated:

The proper analysis, as we see it, is not only to focus on the duty of the defendant, but to allow a flexible standard to meet the varied factual contexts without inhibiting the standard with traditional fault concepts which tend to cloud rather than clarify This flexible approach, as compared to the compartmentalized approach, does away with the necessity of creating a separate pigeonhole for each

106. *Id.* at 906.

107. *Id.* at 907.

108. 495 F.2d 724 (9th Cir. 1974).

109. *Blackie*, 524 F.2d at 905 (citing *White*, 495 F.2d at 724).

defendant whose involvement in the transaction in question may not fit nicely into one of the previously defined classes.¹¹⁰

Blackie and *White* both argue for flexible interpretations of concepts entwined with the broad remedial purposes of the securities laws. In *Blackie*, the focus of inquiry shifted from examination of a technical fraud concept requiring, under common law, a finding of actual reliance, to a conception of fraud consistent with the central aim of the securities laws, which is the "fostering of an expectation that securities markets are free from fraud—an expectation on which purchasers should be able to rely."¹¹¹ The Ninth Circuit noted that effecting the statute's broad remedial purpose, deterring fraud, could best be accomplished by recognizing that "the fraud action must be and has been flexibly adapted to the overriding purpose of enforcing the federal securities laws."¹¹² The court's ultimate rational was simply stated: "We decline to leave open market purchasers unprotected."¹¹³ In *White*, where the Ninth Circuit was concerned with the scienter requirement, the following conclusion was reached: "We believe that the cases and commentators demonstrate that any attempt to limit the scope of duty in all Rule 10b-5 cases by the use of one standard for the state of mind or scienter is confusing and unworkable."¹¹⁴ Whether the central concept at issue is reliance or scienter, the crucial language of these Ninth Circuit cases is flexibility. The court in *White*, in articulating its "flexible duty standard," stated:

We believe this flexible duty standard is desirable in an area as complex as securities fraud litigation and will come more closely to improving the sanctity of information in the marketplace, as Congress intended, without severely hampering the trading of securities and the flow of information It rejects the idea that conduct in complex Rule 10b-5 cases may be neatly compartmentalized into traditional concepts which have often resulted in jamming facts together in an effort to fit the concept.¹¹⁵

Blackie's analysis of the reliance requirement in terms of market impact is similar to the analysis of the fiduciary concept undertaken in Part I. Part I of this note demonstrated that analysis of the fiduciary concept in *Chiarella* consisted of a mere recitation of the tradi-

110. *White*, 495 F.2d at 734. This analysis is strikingly similar to the analysis offered by Professor Weinrib. See *supra* note 56 and accompanying text.

111. *Blackie v. Barrack*, 524 F.2d at 907.

112. *Id.*

113. *Id.*

114. *White*, 495 F.2d at 734.

115. *Id.* at 736.

tional categories of persons to whom the concept fiduciary historically applied,¹¹⁶ and that such a recital is inadequate to serve as an analytical base from which to determine who in the future should be deemed a fiduciary. *Blackie*, rejecting the common law's direct reliance requirement, extended a traditional concept by allowing the goals of the statute to determine its content, thereby allowing the requirement to function effectively.

The Second Circuit, in *Panzirer v. Wolf*,¹¹⁷ examined the question of the relationship of fraudulent misrepresentation and omissions to the integrity of the market. The plaintiff had purchased stock in Allied Artists Industries, Inc., which had filed annual reports alleged to be false. Though plaintiff had not read the annual reports, she brought suit under Section 10(b) and Rule 10b-5 seeking to represent the class of investors purchasing Allied stock after release of the annual report. Plaintiff had, however, relied on *The Wall Street Journal* and the recommendations of her broker. Their favorable recommendations supposedly reflected relatively "accurate and up-to-date information" within the market, including the annual report.

The Second Circuit held plaintiff's reliance on the integrity of the market "stated a sufficient connection between her loss and the allegedly fraudulent annual report to withstand a motion for summary judgment."¹¹⁸ The court stated that "[p]roving reliance is necessarily difficult where the fraud has affected the market and damaged the plaintiff only through its effect on the market."¹¹⁹ Relying on *Affiliated Ute*, the Second Circuit rejected the direct reliance requirement "where the fraud affects the market. . . ."¹²⁰ The court reasoned:

[A]n investor relies generally on the supposition that the market price is validly set and that no unsuspected fraud has affected the price. . . . [Plaintiff] did not rely on the integrity of the market price because she did not rely on the price, but she did rely on the integrity of the market in producing the information reported in *The Wall Street Journal*.¹²¹

The Second Circuit, consistent with *Blackie*, not only analyzed a Rule 10b-5 claim in terms of market impact, expanding the common law concept of reliance to include indirect reliance,¹²² but had to ad-

116. *Chiarella v. United States*, 445 U.S. 222, 232 (1980).

117. 663 F.2d 365 (2d Cir. 1982).

118. *Id.* at 367.

119. *Id.* at 368.

120. *Id.*

121. *Id.*

122. *Id.*

dress the systematic metastasis of deceptive information through the market. One commentator has identified the "key analytical distinction between state and federal securities laws" as state law's focus on the direct relationship between specific buyers and sellers of securities and federal law's addressing the general impact an individual securities fraud may have on overall investment confidence.¹²³ Recognition of a higher duty in risk arbitrageurs, a class of investors whose impact on the market is staggering¹²⁴ and directly related to the routine receipt and use of nonpublic information, is sensible because a successful deterrent policy can prevent a deleterious impact on the market.¹²⁵

On March 7, 1988 the Supreme Court decided *Basic Incorporated v. Levinson*.¹²⁶ In September of 1976, Basic, a publicly traded company, had a number of meetings and telephone conversations with representatives of Combustion Engineering, Inc. concerning the possibility of a merger. During 1977 and 1978, Basic, through its president, made three public statements denying that it was engaged in merger negotiations. The respondents in this action were former Basic shareholders who sold their stock after Basic's first public statement. An action was brought against Basic and its directors, asserting that Basic's false or misleading public statements were in violation of Section 10(b) of the 1934 Act and of Rule 10b-5. They alleged they were injured when they sold Basic shares at artificially depressed prices in a market affected by petitioners' misleading statements.

The District Court presumed members of the plaintiff class had relied on Basic's public statements, but granted summary judgment to defendants holding the misstatements were immaterial as a matter of law. The Court of Appeals for the Sixth Circuit affirmed on the issue of class certification but reversed summary judgment, remanding on the issue of the materiality of Basic's statements. The Supreme Court granted *certiorari* to determine whether the courts below had properly applied a presumption of reliance in certifying

123. Seligman, *supra* note 30, at 1115. Seligman went on to cite the congressional report accompanying the Insider Trading Sanctions Act as support for the proposition that federal law still insists on creating a perception of a fair and honest market in which investors can have confidence: "Insider trading threatens these markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules." *Id.* at 1116 n.159 (quoting H.R. REP. NO. 355, 98th Cong., 1st Sess. 3 (1983)).

124. See *supra* notes 20, 39-40 and accompanying text for an analysis of the impact of risk arbitrage trading on the market.

125. See *supra* notes 36, 81-83; see also *infra* notes 271-88.

126. 108 S. Ct. 978 (1988).

the class; that is, in adopting a presumption of reliance created by the fraud-on-the-market theory.

The Court's discussion of the issues in *Basic* began with a clear statement that "The 1934 Act was designed to protect investors against manipulation of stock prices."¹²⁷ Its discussion on the fraud-on-the-market theory began with a statement of the theory itself:

The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. . . . The casual connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.¹²⁸

Petitioners argued that actual reliance had long been an element of common-law fraud¹²⁹ and that since the analogous express right of action includes a reliance requirement, so too must an action implied under Section 10(b).¹³⁰ The Court agreed that reliance is an element of a Rule 10b-5 cause of action but immediately noted:

The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences. . . . Arising out of considerations of fairness, public policy, and probability, as well as judicial economy, presumptions are also useful devices for allocating the burdens of proof between parties. . . . The presumption of reliance employed in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports the congressional policy embodied in the 1934 Act. In drafting that Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets. . . .¹³¹

The Court went on to quote the House Report:

The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings [sic] about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and

127. *Id.* at 982 (citing S. Rep. No. 792, 73d Cong., 2d Sess. 1-5 (1934)).

128. *Id.* at 988-89 (quoting *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986)).

129. *Id.* at 989.

130. *Id.*

131. *Id.* at 989-91.

secreting of important information obstructs the operation of the markets as indices of real value.¹³²

The Court noted that "[r]ecent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well developed markets reflects all publically available information," . . .¹³³ and that it was difficult to imagine a buyer or seller who did not rely on market integrity.¹³⁴ For these reasons, the Court held that it was appropriate for the court below to apply a presumption of reliance supported by the fraud-on-the-market theory.¹³⁵

Like other cases which applied the fraud-on-the-market theory, *Basic* expressly stated that concepts formulated by the early fraud cases may be inadequate to deal with a changed market.¹³⁶ The Court felt these differences must be reflected in a contemporary reformulation of concepts crucial to Rule 10b-5 analysis.¹³⁷ Since plaintiffs must establish reliance in actions involving securities fraud, a contemporary reworking of the concept has been found to be appropriate since the traditional common law concept of actual reliance, advanced in response to a different set of market exigencies, is no longer a useful means of realizing the purposes of the securities laws. Since buyers and sellers in the market must rely on the information they receive,¹³⁸ the courts should interpret the means pro-

132. *Id.* at 991 (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934)).

133. *Id.*

134. *Id.* (citing *Schlanger v. Four-Phase Systems Inc.*, 555 F. Supp. 535, 538 (S.D.N.Y. 1982)).

135. *Id.* at 993. The Court based its conclusion, in part, on the Court of Appeals for the Second Circuit's acknowledgement that the presumption of reliance may be rebutted by a showing "that the misrepresentation in fact did not lead to a distortion of price or that an individual plaintiff traded or would have traded despite his knowing the statement was false." *Id.* at 992.

136. *Id.* at 989-90.

137. *Id.*

138. If investment in the market is to be something beyond mere luck or gambling, accurate information must be available to every investor. This is not to say that each individual investor must have an exactly equal amount or quality of investment information. Obviously, some investors can invest more resources than others in the legitimate purchase of information. But to the extent that nonpublic information, such as upcoming tender offers are consistently and selectively disclosed to a small class of wealthy and powerful investors, the rest of the market is placed at a disadvantage. *See supra* note 81 and accompanying text. While this selective disclosure is made because of the ability of the person receiving the nonpublic information to use his/her financial resources to help the tender offeror acquire a potential target, at some point, this "disadvantage" to other investors becomes so significant that reasonable judgments must be made as to when wealth ceases to justify the disadvantaging of the majority of investors in the market. Part IV attempts to quantify this point by defining the concept of "significant impact," in such a way that it can be used to determine when traders should be treated as fiduciaries for purposes of imposition of Rule 10b-5 liability. *See infra* notes 252-61 and accompanying text.

vided by the securities laws to ensure market integrity in a way which will allow those laws to operate efficiently.

One of those means has been and continues to be liability under Rule 10b-5, which, under *Chiarella*, requires a finding of fiduciary duty. Just as the fraud-on-the-market cases have recognized that the concept of reliance appropriate for face-to-face transactions is inappropriate to the contemporary market, the fiduciary concept, analyzed in categorical common law terms, should also be recognized as inappropriate. The fraud-on-the-market cases have looked to the purposes of the securities laws as a guide to help determine and articulate a reliance requirement appropriate for Rule 10b-5 analysis. Those courts applying the fraud-on-the-market theory have understood the evolutionary nature of fraud within the market and like reliance under the fraud-on-the-market theory, the concept fiduciary must be explicated by analyzing the securities context in which it will function as a means of ensuring the stability of the market and its integrity.¹³⁹

The failure of the courts to functionally analyze the fiduciary concept has created in some commentators a temptation to abandon the fiduciary concept as an integral part of Rule 10b-5 analysis.¹⁴⁰ Perhaps the most cogent statement in support of this position has been set forth by Professor Kaplan, who has written:

The term fiduciary is variously applied to a large number of persons in diverse capacities who resemble each other in that each of them has duties to another; but those duties may vary and differ in many respects. The term 'fiduciary' is applied to the employee and the agent, to the partner and the officer, to the trustee and to the investment advisor, to that chameleon-like character called the insider or sometimes the tippee, to the majority shareholder and the corporate director, to the parent corporation and the shareholders' control group, and perhaps it may come to be applied to a large number of other persons not yet identified. The usefulness and actual effect of such an umbrella term to designate so many different kinds of individuals in divergent capacities with duties of differing character and intensity may well be seriously questioned. The concept of a 'fiduciary' may serve as a useful legal fiction to stimulate development of new or expanding obligations by analogy to the seminal concept of trustee. On the other hand, clarity of description and precision in defining duties might at this stage better be achieved through abandonment of so amorphous a term in favor of developing a more precise set of notions of duty and

139. See *supra* notes 126-38 and accompanying text.

140. This note strongly urges the retention of the fiduciary framework, functionally analyzed in a manner consistent with the Supreme Court's recent adoption of a functional analysis of the reliance requirement under *Basic*.

responsibility in connection with each of the separate capacities now lumped within the broad and nebulous term 'fiduciary.'¹⁴¹

A number of considerations, however, suggest that abandonment of the fiduciary concept would not be particularly helpful in realizing the ends sought by Professor Kaplan. First, it would be extraordinarily difficult to persuade courts to abandon the fiduciary concept. Since it is one of the most fundamental concepts of corporate and securities law and since courts are obviously comfortable with it, attempts to disassociate the fiduciary concept from Rule 10b-5 analysis would likely be resisted by the courts. More importantly, there is no reason to believe that abandonment of the fiduciary concept in favor of the specification of a more "precise set of notions of duty"¹⁴² would actually save the court any time, energy, or cost. The analysis which the courts would be constrained to conduct in specifying these more precise notions would probably be an analysis similar, if not identical, to an analysis which would functionally explicate the term fiduciary.

A functional analysis of a general term restricts explication of that term to a particular linguistic context and generates an analysis of the term for that context. By tailoring the analysis of the term to the restricted legal context in which it is to operate, the difficulties articulated under the logical/linguistic theory are minimized. The logical/linguistic theory asserts that the amorphous nature of the term fiduciary has been necessitated by the complexity and diversity of the different relations it has had to cover. But once a single, monolithic explication of the term fiduciary is no longer demanded as a basis for analysis, the logical necessity which keeps the term fiduciary amorphous evaporates.

One of the consequences of this analysis is that a person who is a fiduciary for purposes of the imposition of Rule 10b-5 liability might not turn out to be a fiduciary for purposes of liability under other legal rules. However, the fact that non-identical sets of individuals might be picked out by multiple, functional analyses of the term fiduciary in different legal situations should not be deemed a serious problem. Under *Basic*, individuals may be said to rely in the Rule 10b-5 context whereas they would not be said to rely under a common law action for fraud. Further, it should be pointed out that a

141. Kaplan, *supra* note 50, at 886. Kaplan's analysis of the fiduciary concept is strikingly similar to Wittgenstein's analysis of "games."; *see supra* note 59; *see also supra* note 72 and accompanying text.

142. Kaplan, *supra* note 50, at 887.

functional explanation of the term fiduciary would not leave the range of individuals who would be fiduciaries in the Rule 10b-5 context wholly indeterminate. The retention of the language fiduciary with all its historical connotations, including those classes of individuals to whom fiduciary principles have historically applied, would place significant constraints on the functional explication of the term offered in diverse legal contexts. All those historical reasons why persons in particular positions have been construed fiduciaries would become part of a functionally explicated fiduciary concept for purposes of Rule 10b-5. This would prevent wholly novel uses of the term fiduciary.

In attempting to analyze whether a trader like Boesky should be a fiduciary, one would ask whether Boesky occupied the type of position traditionally associated with fiduciary duties. Though risk arbitrageurs have never been held to be fiduciaries in prior cases, arbitrageurs' access to nonpublic information is similar to that of officers and directors who have been held to be fiduciaries. Boesky's opportunity to take advantage of this information by virtue of access to corporate resources and financing, unavailable to the vast majority of market peripherals, is certainly more similar to officers and directors of corporations than that of Chiarella, working in the print shop. Further, Boesky's ability to disadvantage investors in the market is also similar to that of corporate officers and directors whose access to corporate information and resources would give them a significant advantage over other investors were they not constrained by fiduciary duties. Chiarella, in contrast, was in a position disanalogous in almost every respect to traditional common law fiduciaries.

Because a functional analysis of the term fiduciary would take place in a legal context, specifically a Rule 10b-5 context, and because it would simultaneously take place in the wider context of historical precedent and analysis as to who have been held to be and should be fiduciaries, a level of predictability in the entities likely to be selected as fiduciaries in different legal contexts is assured. This seems, in practical terms, to accomplish the same analytical and clarifactory goals as Professor Kaplan's proposal, but avoids the radical step of eliminating a concept which, for better or worse, has been and continues to be an integral part of Rule 10b-5 analysis.

PART III

While the cases articulating the fraud-on-the market theory developed in the context of an increased sensitivity to the integrity of the

market itself, a separate line of cases developed in the Second Circuit as a reaction to the limitations of the categorical fiduciary approach of *Chiarella*. Starting with *United States v. Newman*,¹⁴³ these cases utilized a misappropriation theory which attempted to fill in the gaps left open in the *Chiarella* decision.¹⁴⁴ This was accomplished by "extend[ing] liability under Section 10(b) to persons who trade in violation of a duty owed to persons other than the individuals with whom they trade, especially to their employers or the clients of their employers."¹⁴⁵

Relying primarily on agency principles, the misappropriation theory holds that an agent has a duty to refrain from profiting personally by using confidential information acquired during the course of his employment.¹⁴⁶ As in the *Chiarella* approach, the misuse of confidential information under the misappropriation theory is insufficient to state a cause of action in a misappropriation case absent a finding of a fiduciary or other similar duty.¹⁴⁷ Unfortunately, like *Chiarella*, the cases decided under the misappropriation theory provide virtually no analysis of the fiduciary concept.

The development of the misappropriation theory and its relation to the market impact theory presented above¹⁴⁸ cannot be fully understood without noting an important change which took place in the Supreme Court membership eight years prior to *Chiarella*. In 1972, former Justice Powell and current Chief Justice Rehnquist joined the Court. Their arrival initiated a period of strict construction of the securities laws, reversing a long period of liberal interpretation thought appropriate to a statute hitherto perceived as fundamentally

143. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

144. See Langevoort, *supra* note 39, at 211-12. ("[T]he misappropriation theory . . . achieves . . . a measure of fair play in the market that was lost in the doctrinal rigidity of *Chiarella's* abstain or disclose approach [, and that] accords with the investor confidence building intent of the securities law generally."); *Report of the Task Force on Regulation of Insider Trading*, 41 BUS. LAW. 223, 235 (1985) [hereinafter *Report*] ("To reduce the gaps in regulation created by literal application of . . . *Chiarella* . . . , the Second Circuit and several district courts, at the urging of the SEC and federal prosecutors, have increasingly relied upon a 'misappropriation' theory to support liability under Section 10(b) in SEC and criminal actions.").

145. *Report*, *supra* note 144, at 235-36.

146. See Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 982; see also Barry, *supra* note 34, at 1360-65 (common law prohibition concerning use of confidential information by agent for purposes unrelated to principal's intent); RESTATEMENT (SECOND) OF AGENCY § 388 Comment C (1958) (duty to account for profits arising out of employment).

147. *Report*, *supra* note 144, at 236.

148. See Part I.

remedial.¹⁴⁹ Applying strict constructionism, the Supreme Court, when confronted with a question of statutory interpretation, first looks to the statute's wording. In the event that an answer to an interpretive problem is not clear from the precise language of the text, the Court then consults legislative history. Ultimately the Court may be forced to look to policy considerations. However, in the words of one commentator, "more often than not the policies considered are extraneous to the purpose of the securities laws."¹⁵⁰ Criticizing strict constructionism, it has been argued that application of the doctrine "tends to roll back statutes to the years 1933-34, when many of the problems were quite different than in the 1980s. As a result, the statute [10(b)] has become firmly etched in the granite of fifty years ago."¹⁵¹ By relying on "painstaking textual analysis of statutory language and of subtle colorations of commonly used words," another critic has noted the Court, in Section 10(b) analysis, engages in "fatuous analysis of subtleties that never existed."¹⁵² It has been argued that this major change in the analysis of Rule 10b-5 questions provides an explanation for the almost universal failure of plaintiffs' actions brought under Rule 10b-5 at the Supreme Court since 1975.¹⁵³

In an attempt to escape this recent restrictive approach to analyzing Rule 10b-5 cases,¹⁵⁴ the culmination of which was the decision in

149. See Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L. J. 263 (1981) [hereinafter *Discourse*]; Branson, *Statutory Securities Fraud in the Post-Hochfelder Era: The Continued Viability of Modes of Flexible Analysis*, 52 TULANE L. REV. 50 (1977); Note, *Judicial Retrenchment Under Rule 10b-5: An End to Rule as Law?*, 1976 DUKE L.J. 789.

150. *Discourse*, *supra* note 149, at 286.

151. *Id.* at 287.

152. Feller, *Aaron Case: A Technical Analysis Out of Touch With Today's Markets*, NAT'L L.J., June 30, 1980, at 29, col. 1.

153. Professor Branson notes that in the period between 1975 and 1981, only one securities case had been specifically decided in favor of a plaintiff. See *United States v. Naftalin*, 441 U.S. 768 (1979), and the Court decided two dozen or more corporate securities cases for defendants. *Discourse*, *supra* note 149, at 288-89.

154. The Supreme Court's move away from liberal construction of Section 10(b) began in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The Court in *Blue Chip*, reversing the Ninth Circuit, reaffirmed the judicially created *Birnbaum* rule articulated in *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, *cert. denied*, 343 U.S. 956 (1952) (the *Birnbaum* rule requires a plaintiff be either a purchaser or seller of securities in order to have standing to sue under Rule 10b-5). Justice Rehnquist argued that, absent actual purchase or sale of securities, "bystanders to the securities marketing process could await developments on the sidelines without risk, claiming that inaccuracies in disclosure caused nonselling in a falling market and that unduly pessimistic predictions by the issuer followed by a rising market caused them to allow retrospectively golden opportunities to pass." *Bluechip*, 421 U.S. at 747. Justice Rehnquist noticed that the majority of commentators viewed the *Birnbaum* limitation

Chiarella, the SEC and lower courts sought alternative theories of Rule 10b-5 liability including the misappropriation theory.¹⁵⁵ Though a majority of the Court in *Chiarella* refused to entertain it for procedural reasons,¹⁵⁶ the misappropriation theory has been increasingly relied upon by the SEC because a number of Justices made clear in *Chiarella* that they favored it. Then Chief Justice Burger, a supporter of the theory argued in dissent, that where non-public information is misappropriated, an absolute duty to disclose that information or refrain from trading is imposed by the securities laws.¹⁵⁷ Reasoning that the anti-fraud provisions of the securities laws were designed in large measure to assure that securities dealings would be "fair and without undue preference advantages among investors,"¹⁵⁸ Burger concluded:

Chiarella, working literally in the shadows of the warning signs in the printshop, misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securi-

as an "arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in fact been caused by violations of Rule 10b-5." *Id.* at 738. Nonetheless, he argued that the securities laws, as carefully and precisely drafted documents, did not expressly indicate that its protections should extend to persons other than actual purchasers and sellers. *Id.* at 736. "Therefore," he stated, "[i]t would indeed be anomalous to impute to Congress an intention to expand the plaintiff class for a judicially implied cause of action beyond the bounds it delineated for comparable express causes of action." *Id.* The following year, in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Court held that mere negligence was not a sufficient ground for imposing Rule 10b-5 liability. Reasoning that carefully drawn congressional limitations would be undermined if the Court recognized negligent misconduct actionable under Rule 10b-5, Justice Powell concluded that "[w]hen a statute speaks so specifically in terms of manipulation and deception, . . . and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct." *Id.* at 214.

155. See Langevoort, *supra* note 49, at 209. ("The misappropriation theory has become the primary vehicle for reaching nontraditional trading cases, those that are neither clear cut insider or tippee cases, nor proscribed explicitly by Rule 14e-3."); Note, *Insider Trading: Circumventing the Restrictive Contours of the Chiarella and Dirks Decisions*, 1985 U. ILL. L. REV. 503, 520-21 (to combat flagrant abuses in the stock markets, the SEC has invoked temporary insider and misappropriation theories).

156. In *Chiarella*, the government argued that *Chiarella* had "breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation." *Chiarella*, 445 U.S. 222, 235 (1980). The Court refused to apply the misappropriation theory stating "Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury [citations deleted] we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of 10(b)." *Id.* at 236-37.

157. *Chiarella*, 445 U.S. at 240.

158. *Id.* at 241.

ties in the market. In my view, such conduct plainly violates § 10(b) and Rule 10b-5.¹⁵⁹

Justice Stevens, who concurred, wrote separately to emphasize that the Court had not decided whether Chiarella's duty of silence "unquestionably owed to his employer" could give rise to criminal liability under Rule 10b-5,¹⁶⁰ and noted that "[r]espectable arguments could be made in support of either position."¹⁶¹ He concluded, "[T]he Court wisely leaves the resolution of this issue for another day."¹⁶² Justice Brennan, who also concurred, agreed with the Chief Justice that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."¹⁶³

The misappropriation theory, prior to *United States v. Newman*,¹⁶⁴ had never provided a basis for either civil or criminal liability under Rule 10b-5. *Newman* involved a criminal action brought by the SEC¹⁶⁵ in which two employees of Morgan Stanley & Company, Inc. and Kuhn Loeb & Company, were tried for conveying confidential information about proposed mergers and acquisitions to a number of co-conspirators.¹⁶⁶ Defendant Newman and his cronies used information that had been entrusted to Morgan Stanley and Kuhn Loeb by corporate clients, to purchase stock in companies that were merger and take-over targets of those clients.¹⁶⁷ The Second Circuit held that a criminal violation of Section 10(b) and Rule 10b-5 had occurred, notwithstanding that neither Morgan Stanley, Kuhn Loeb, nor their clients were, at the time, purchasers or sellers of the target securities.¹⁶⁸ The Court noted Rule 10b-5 makes it unlawful for any person to engage in any act or practice which operates as a fraud or deceit upon any person in connection with the purchase or sale of any security, and that the language of Rule 10b-5 contains no specific requirement that the fraud be perpetrated upon the seller or

159. *Id.* at 245.

160. *Id.* at 238.

161. *Id.*

162. *Id.*

163. *Id.* at 239.

164. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

165. The fact that *Newman* was a criminal action would take on particular importance in the Second Circuit where standing to sue was denied plaintiffs in a civil damage action. *See Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984), discussed *infra* notes 171-82.

166. Morgan Stanley & Co., Inc. and Kuhn Loeb & Co. are now Lehman Brothers Kuhn Loeb, Inc.

167. *Newman*, 664 F.2d at 16.

168. *Id.* at 19.

buyer of securities.¹⁶⁹ Citing Chief Justice Burger's dissent in *Chiarella*, the court concluded that the defendant "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."¹⁷⁰ By trading on confidential nonpublic information, the *Newman* defendants "sullied the reputations" of Morgan Stanley and Kuhn Loeb, "as safe repositories of client confidences . . . defraud[ing] those employers as surely as if they took their money."¹⁷¹

In *Newman*, the Second Circuit stated that "proscription of fraudulent and deceptive practices upon any person in connection with a purchase or sale of a security provided clear notice to [Newman] that his fraudulent conduct was unlawful."¹⁷² Judge Dumbauld, in partial dissent, argued that just as in *Chiarella*, the defendants "owed no duty to the sellers of the target company securities which they purchased."¹⁷³ Therefore, "though they deceptively and improperly violated a fiduciary duty to their employers, those parties had not at that time actually purchased or sold any target company securities."¹⁷⁴ Judge Dumbauld concurred on the ground that there had been a violation of the mail fraud statute but asserted he could find no duty breached to those individuals who purchased and sold securities.¹⁷⁵ Such a finding, according to Dumbauld, would be a necessary condition for the imposition of Rule 10b-5 liability.¹⁷⁶

A number of problems with *Newman* immediately became apparent to commentators. First, since the misappropriation theory focuses attention on the employee's duty to his employer as an employee rather than the employee's duty to purchasers and sellers in the market as an investor, the misappropriation theory presents a significant departure from traditional Rule 10b-5 analysis. Traditional analysis required that the person allegedly defrauded by a misappropriator be engaged in some investment related activity in order to establish Rule 10b-5 liability.¹⁷⁷ In *Newman*, the injury to the employer's rep-

169. *Id.* at 16, 17.

170. *Id.* at 17 (citing *United States v. Chiarella*, 445 U.S. 222, 245 (1980)).

171. *Newman*, 664 F.2d at 17.

172. *Id.* at 19.

173. *Id.* at 20.

174. *Id.*

175. *Id.* at 20-21.

176. *Id.*

177. Langevoort, *supra* note 32, at 46; see also Shapiro, *Securities: Rule 10b-5 and Insider Trading—United States v. Carpenter*, 10 HARV. J.L. & PUB. POL'Y. 265, 268 (1987) ("Rule 10b-5 liability should logically have some relationship to the deceived person's decision to trade, but the misappropriation theory is primarily aimed at the harm caused by the informational source, not the securities investor.").

utation was sufficient to constitute fraud within the meaning of Rule 10b-5 notwithstanding Newman owed no duty to actual purchasers and sellers of stock in which he traded and his employer was not engaged in any investment related activity.¹⁷⁸ It has been noted that this position is inconsistent with *Santa Fe Industries, Inc., v. Green*¹⁷⁹ which holds that Section 10(b) violations must be based on allegations of manipulation, deception or nondisclosure.¹⁸⁰ A mere breach of a fiduciary duty absent securities related fraud would be inadequate to sustain Rule 10b-5 liability.¹⁸¹ Similarly, *Ernst & Ernst v. Hochfelder*¹⁸² makes clear that the focus of the securities laws is the protection of investors against fraud.¹⁸³ The securities laws were not intended to govern employer-employee relations, but were intended to protect the integrity of the securities market.¹⁸⁴

178. *Newman*, 664 F.2d at 17; see also Note, *The SEC's Regulation of the Financial Press: The Legal Implications of the Misappropriation Theory*, 52 BROOKLYN L. REV. 43 (1986) [hereinafter Note, *Financial Press*]. The note explained how

the *Newman* and *Materia* cases do not stand for the proposition that, for misappropriation to be actionable, the harm to the employer must also encompass some harm to a client. The *Materia* decision in particular suggests that defrauding the employer is a sufficient predicate for liability under the misappropriation theory, and that a demonstration of adverse effects outside the employer/employee relationship is unnecessary.

Id. at 79.

179. 430 U.S. 462 (1977).

180. See Note, *Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far*, 61 ST. JOHN'S L. REV. 78 (1986) [hereinafter Note, *Misappropriation Theory*]. "[I]t is questionable whether the misappropriation theory by itself satisfies the requirements of *Santa Fe*." *Id.* at 103-04; accord *Silver*, *supra* note 146. "Basing a violation of Rule 10b-5 on the defendant-employee's breach of . . . duty to the employer . . . is inconsistent with judicial constructions of the provision, which predicate liability on injury to persons to whom a duty is owed." *Id.* at 982.

181. *Santa Fe*, 430 U.S. at 476; see also *Brudney*, *supra* note 35, at 350 (*Santa Fe* distinguishes between federally forbidden "deception" and a "unilateral" expropriation in violation of a local fiduciary duty).

182. 425 U.S. 185 (1976).

183. *Id.* at 195.

184. 3A H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 9.21(a)(c) at 9-114.8 (rev.1987); *Aldave*, *supra* note 16 at 119-20:

Although one who misappropriates confidential information deceives the person who entrusted the information to him, the ultimate damage may be suffered by others . . .

[In *Newman*], whether or not those parties suffered economic harm, the deceit that was practiced on them resulted in financial injury to members of the investing public.

Id.; *Silver*, *supra* note 146, at 983 ("[t]he statute is designed primarily to protect investors and the 'injured' party, the employer is not among them") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976) and *United States v. Newman*, 664 F.2d 12, 20 (2d Cir. 1981) (Dumbauld, J., concurring and dissenting), *cert. denied*, 464 U.S. 863 (1983)); Note, *Misappropriation Theory*, *supra* note 180, at 108 ("the misappropriation theory erroneously focuses on protection of corporate entities and employers rather than investors.").

With respect to the issue of the misfocus of the misappropriation theory, it is important to distinguish theories of liability which incidentally influence employer-employee relations from theories of liability whose purpose and essential function is to affect those relations. The fact that the employer-employee relation will be positively influenced by a rule which constrains employee misconduct in the context of securities related transactions does not mean it is necessary to base justification for imposing Section 10(b) liability on what can be viewed as an incidental positive effect.¹⁸⁵ While *Newman* identified employer reputation as an interest injured by employee misappropriation of securities related information,¹⁸⁶ and found injury to this interest a sufficient basis for Section 10(b) liability,¹⁸⁷ the *Newman* court did not state that Newman's employer's reputation was the only interest injured. In fact, the court in *Newman* identified artificial inflation of stock prices as another injury.¹⁸⁸ The court stated:

Appellee [Newman] and his cohorts also wronged Morgan Stanley's and Kuhn Loeb's clients, whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information. In a tender offer situation, the effect of increased activity in purchases of the target company's shares is, similarly, to drive up the price of the target company's shares; but this effect is damaging to the offering company because the tender offer will appear commensurately less attractive and the activity may cause it to abort.¹⁸⁹

Whether a particular use of misappropriated information violates a fiduciary duty or not, a number of commentators have taken the position that since the integrity of the market is injured by misappropriation, imposition of Section 10(b) liability under the misappropriation theory makes sense on policy grounds.¹⁹⁰ Professor Bloomenthal, for example, has written:

185. Whether a particular effect of a legal rule is "incidental" to some other purpose must be determined by examining both the intent of those who fashioned the rule and the actual practice of imposition of the rule. No language in the text of any decision invoking the misappropriation theory suggests that the *primary* reason courts have invoked the misappropriation theory is to positively influence employer/employee relations. On the other hand, the cases utilizing the misappropriation theory are fundamentally unconcerned with the effect that use of misappropriated information has on the market itself. See text following note 248.

186. *Newman*, 664 F.2d at 17.

187. *Id.* at 17-18.

188. *Id.*

189. *Id.*

190. H. BLOOMENTHAL, *supra* note 184, at 9-114.7-.8. (Bloomenthal argues that in *Newman*, even if there had been no unlawful trading, purchasers would have been equally hurt

In view of the purpose of the securities laws to protect the integrity of the securities markets, a misappropriation of information theory is obviously appropriate from a policy standpoint. A policy analysis suggests, however, that it is not to protect the party from whom the information is stolen, but rather it is the securities markets that make it appropriate to apply Rule 10b-5.¹⁹¹

The need to safeguard the integrity of the market provides the requisite link between the misappropriation of nonpublic information and application of the securities laws. Besides its beneficial effect on the integrity of employer-employee relations, application of the misappropriation theory has two additional positive effects directly on the market itself. First, it protects the investing public from trading with individuals possessed of an improperly obtained informational advantage. Second, as suggested by *Newman*, the imposition of Section 10(b) liability on persons who misappropriate confidential information will decrease the "artificial inflation of stock prices."¹⁹² Since these effects are consistent with the fundamental purposes of the securities laws,¹⁹³ they provide at least some policy oriented justification for the misappropriation theory, independent of the employer-

since the withholding of information, rather than trading on the basis of inside information, would be the harm on which to predicate liability). *But see* Titus, *Netting the Outsider: The Need for a Broader Restatement of Insider Trading Doctrine*, 8 W. NEW ENG. L. REV. 127, 148 (1986) (criticizing the misappropriation theory for not focusing on the "real issues" which include unjust enrichment of misappropriators, losses suffered by traders who did not have access to the same information, and "the injury to the integrity of the securities markets themselves.").

191. H. BLOOMENTHAL, *supra* note 184, at 9-114.8.

192. Though *Newman* did not state that artificial inflation of stock values would decrease if the misappropriation theory were adopted universally, it is obvious that the court would hold this to be at least one positive effect of the theory's application.

193. Seligman, *supra* note 30, at 1151. ("[F]ederal law . . . addresses the general impact an individual securities fraud may have on overall investor confidence."). Legal rules which preclude the use of improperly obtained investment information to the disadvantage of the investing public are consistent with the purposes of the securities laws which in large measure were designed to restore confidence in the market. Congressman Lea, introducing the final Securities Exchange bill to the House for floor discussion, emphasized: "The real purpose of this regulatory measure is to protect the investors of the United States against fraud and imprudent investments, and to give integrity to the securities by the sale of which American business must be financed." 73 CONG. REC. H. 7861 (daily ed. May 1, 1934). The House Report stated that "[t]he idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price." H.R. REP. NO. 1383, 73d Cong., 2d Sess. 11 (1934). Where a misappropriation and use of investment information artificially inflates the value of securities, that value in the market ceases to reflect the actual investment value of those securities rendering the market less efficient and undermining the confidence of investors who rely on the integrity of the market as an efficient mechanism for determining the investment value of securities. *See also supra* note 80. *But see* Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970) (use of inside informa-

employee context. Where there is an issue as to the legitimacy of a theory of liability under a particular statute or rule such as Section 10(b) or Rule 10b-5, however, the mere existence of some beneficial effect on the market itself is only one factor to consider.

In response to *Newman's* alleged inconsistency with *Santa Fe* on the requirement of deception, proponents of the misappropriation theory have admitted that *Newman* gave short shrift to the fraud issue.¹⁹⁴ *Newman* itself stated "we need spend little time on the issue of fraud and deceit."¹⁹⁵ The court believed little time was needed on the fraud issue because the misappropriation theory is primarily focused on the employee's activities qua employee rather than the employee's role as a market participant whose actions have an effect on the market. It held that when an employer has been deceived by the employee who uses confidential information for a purpose other than that for which it was intended and such misappropriation is for the purpose of purchasing securities, there seems to be little reason to look beyond the employer-employee relation to find further deception. A further finding of deception would arguably be superfluous for purposes of satisfying *Santa Fe*.

The Second Circuit found the breach of confidentiality by *Newman* and his cohorts supplied the requisite duty breach to find a Rule 10b-5 violation. Injury to both the reputation of the investment banker employers and their corporate clients in connection with the purchase and sale of securities provided a sufficient securities related context to justify this imposition of liability. Critics of the misappropriation theory have argued that to assert actionable securities fraud has occurred simply because someone has been misled ignores *Chiarella's* holding that only those breaching a duty to those injured by the purchase or sale of securities are liable under the securities laws.¹⁹⁶ Since the misappropriator has no general duty to the market under *Chiarella*, and no duty to his employer's clients, no securities

tion increases efficiency of the market by disseminating accurate information quickly and efficiently).

194. See, e.g., Aldave, *supra* note 16, at 117-18; Note, *Financial Press*, *supra* note 178, at 68 ("Newman . . . did not actually distinguish Newman's breach of his fiduciary duty from the defendant's breach in *Santa Fe*, nor did it adequately explain why the former constituted 'fraud' while the latter did not. The court analyzed the fraud issue summarily. . ."). *Id.* at 67-68.

195. *Newman*, 664 F.2d 12, 17 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

196. Note, *Misappropriation Theory*, *supra* note 180, at 112 ("Federal legislation should not attempt to remedy every inequity in the securities market. Likewise, not all insider trading that violates moral or ethical principles violates current securities laws." *Id.* (citing *Chiarella*, 445 U.S. 222, 232 (1980))).

related deception should occur for purposes of Section 10(b), using the *Santa Fe* analysis.¹⁹⁷ Thus, continues the argument, while the deception of the employer and subsequent damage to his reputation are certainly important interests worthy of protection, there is no reason why they singly, or in conjunction, should establish securities fraud. Since common law actions for fraud provide a sufficient remedy for an employer injured by a securities related misappropriation, there appears to be no reason to find such misappropriation a violation of the securities laws and, in particular, a violation of Rule 10b-5.¹⁹⁸ Further, it is unclear why the misappropriation should be viewed as deception at all under *Santa Fe* since, arguably, all that has occurred is the breach of an employment contract.¹⁹⁹

In answer to the first criticism, the fact that an employer has been deceived does not mean he was the only party deceived by the misappropriator. Just as the effect of the misappropriator's use of confidential information impacts on both the employer-employee relation and the market itself, two separate frauds are committed by the misappropriating employee—one on his employer and one on the market as a whole.²⁰⁰ To respond to the second criticism, the basis of the claim that the deception of the investing public could constitute

197. See Report, *supra* note 11, at 237. It can be argued that the misappropriation theory is inconsistent with *Santa Fe Industries, Inc. v. Green*. The task force believes that the lower courts' development of the misappropriation theory since *Chiarella* and *Dirks* reflects less a reasoned application of those decisions than a recognition of the significant regulatory gaps that would be created if the *Chiarella/Dirks* analysis alone were strictly followed; see also Heller, *Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory*, 37 BUS. LAW. 517 (1982):

It is difficult to understand how the fact that one who has expropriated information from others can create fiduciary obligation (and consequent liability) to target company shareholders with whom he had no relationship whatsoever and who were unaware of the 'theft' or had any reason to believe that such information existed. No historical precedent in the Supreme Court or elsewhere was cited by Justice Burger (in *Chiarella*) for his proposition of law.

Id. at 535.

198. Note, *Misappropriation Theory*, *supra* note 180, at 112 "Common law agency principles can adequately protect the confidential information of employers without using federal securities laws in a manner for which they were neither designed nor intended." *Id.*; see also Arkin, *supra* note 18, at 1.

199. See Titus, *supra* note 190, at 146 "[T]he conduct which constitutes a breach of duty in cases such as *Newman* . . . sounds more like a breach of contract than a deception or misrepresentation regarding the purchase or sale of securities." *Id.*

200. See Aldave, *supra* note 16, at 114 ("Under the analysis of Chief Justice Burger and Justice Brennan . . . *Chiarella*'s misappropriation of nonpublic information subjected him to an absolute duty to disclose that information or refrain from trading so that his trading without disclosure constituted a fraud on the other parties to his transactions, or on the entire marketplace"). *Id.*; Wuller, *Insider Trading: Circumventing the Restrictive Contours of the Chiarella and Dirks Decisions*, 1985 U. ILL. L. REV. 503. The misappropriator "[i]s committing a fraud

fraud under *Santa Fe* is found within *Newman* itself. The artificial inflation of stock prices caused by Newman and his cohorts' trading and the derivative effects of that trading, once disclosed, on Morgan Stanley and Kuhn Loeb's securities related businesses may have been extensive enough to justify finding a higher duty in the misappropriator grounded on a market impact theory.²⁰¹ Had such a theory been considered in *Newman*, the effects of the trading of Morgan Stanley's and Kuhn Loeb's employees on the market directly through their own dealing and indirectly through the impugning of their employer's reputations would have provided a focus of inquiry directly related to the securities markets rather than the employer-employee context.²⁰² Unfortunately, *Newman's* exclusive focus on the employer-employee relation precluded such a finding, and instead, the Second Circuit was forced to try and generate a fraud for Rule 10b-5 purposes from a simple breach of duty to an employer and its clients.

The market impact theory presented in Parts I and II of this article is not susceptible to either the criticism that it is improperly focused or that it cannot satisfy *Santa Fe*. Since the market impact theory directs attention to the actual effect of improper use of non-public information on the market, it is unconcerned with how the information was acquired. For this reason, it does not focus on the employer-employee relation. Since the market impact theory defines the fiduciary concept in terms of the degree of impact which improper trading has on the market, trading sufficient to generate a fiduciary duty, as will be discussed in Part IV, will by definition have so wide ranging an effect as to ensure the deception of virtually every trader in an affected security. *Santa Fe*, for this reason, necessarily poses no threat to the market impact theory.

on the market as a whole" when investors who buy and sell securities on the market believe in the integrity of the stock exchange. *Id.* at 524 (emphasis added).

201. The issue of when a particular impact on the market should justify imposition of a higher duty on the person trading on the basis of nonpublic information is discussed in Part IV. See *infra* notes 252-60.

202. While *Newman* identified employer reputation as a protected interest, *Newman* never analytically tied employer reputation to the underlying purposes of the securities laws. An employer's reputation in the securities market can itself impact on the market. For example, where clients refuse to deal with a company because of the company's reputation for dishonesty or illegal actions result in a significant loss of business, an impact could be felt in the market as a whole. Where publicity is extremely dramatic, as in the Boesky case discussed in Part I, the reputation of an entire industry can be called into question. See *supra* notes 4-7 and accompanying text.

A third difficulty undermining the effectiveness of the misappropriation theory involves the holding of *Moss v. Morgan Stanley*,²⁰³ a case which arose out of the same facts as *Newman*. *Moss* held, in a civil action for damages, that target shareholders who traded stock in the open market with the *Newman* defendants,²⁰⁴ had failed to state a claim for damages under Section 10(b) and Rule 10b-5 because they were owed no duty by the inside traders.²⁰⁵ The court noted that “*Moss*’ theory is that any person who ‘misappropriates’ information owes a general duty of disclosure to the entire market place.”²⁰⁶ Since this theory had been rejected in *Chiarella*, plaintiffs were denied standing to sue.²⁰⁷

It has seemed anomalous to some commentators that the Second Circuit should uphold a criminal conviction in *Newman* based on the misappropriation theory while denying standing in a civil suit to persons who were victims of the same act.²⁰⁸ The problem, in the words of one commentator, is:

Normally, the corporate employer would lack standing to sue the employee for the securities law breach of duty. Rule 10b-5 limits standing to actual purchasers or sellers of stock during a fraud. [sic] [P]ersons who were reciprocal buyers or sellers of employees who breached a duty to their employers would lack standing because no duty was breached to them. And the employer to whom a duty was breached normally would lack standing because it purchased no stock. The SEC and the Department of Justice could continue to prosecute suits whenever these agencies could identify any breach of duty. But the lack of private plaintiffs would reduce the deterrent force of Rule 10b-5.²⁰⁹

Because *Moss* severely restricted private plaintiff recovery, few private plaintiffs now seek recovery solely under the misappropriation

203. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

204. *Id.* at 8.

205. *Id.* at 15.

206. *Id.* at 16.

207. *See* Block, Barton, Babich, *SEC Litigation*, 15 SEC. REG. L. J. 299, 305 (1987).

208. *See* Seligman, *supra* note 30.

209. *See* Seligman, *supra* note 30, at 1127; *see also* Note, *Misappropriation Theory*, *supra* note 180:

[T]he most significant deficiency in current statutory and case law regarding insider trading is the lack of a remedy for private investors defrauded by traders with whom they have no fiduciary relationship. Despite recent SEC successes in exposing and penalizing insider trading, private investors still find themselves without a remedy when no fiduciary relationship exists between the insider and the defrauded investor.

Id. at 111.

theory.²¹⁰ Many are turning to the Racketeer Influenced and Corrupt Organization Act [RICO].²¹¹

The standing problem raised by *Moss*, however, while undermining the deterrent force of the misappropriation theory, creates no difficulty for the market impact theory. Under the market impact theory, purchasers and sellers in the market would be directly owed a duty by the misappropriator trading on confidential nonpublic information.²¹² Such trading, if its impact were *significant* in the sense specified in Part IV of this note, could constitute a breach of duty directly to the injured parties, and as such, serves as a predicate for the imposition of civil liability under Section 10(b). Because the market impact theory imposes no general duty on all investors, but rather, imposes a higher level of duty on a limited class of investors based on the actual effect their trading has on the market, the market impact theory is, in this respect consistent with *Moss* and *Chiarella*.²¹³

Of the recent insider trading cases prosecuted under the misappropriation theory, perhaps the most publicized has been *United States v. Carpenter*.²¹⁴ In a four-four decision, the Supreme Court upheld the conviction of R. Foster Winans who had been convicted of violating Section 10(b), Rule 10b-5, and the federal mail and wire fraud statutes.²¹⁵ Winans, a reporter for *The Wall Street Journal*, entered into a scheme with a number of co-conspirators²¹⁶ to give advance information to individuals concerning the timing and contents of the *Heard on the Street* column of *The Wall Street Journal*. Winans was one of two writers of this daily column which discussed and selected stocks or groups of stocks giving positive and negative infor-

210. Note, *Misappropriation Theory*, *supra* note 180, at 111.

211. *Id.*

212. *See supra* Part I.

213. This is not to suggest that the duty theory articulated in *Chiarella* and the misappropriation theory articulated in *Newman* are consistent in every respect, which is of course, a central thesis of Parts I and III.

214. 791 F.2d 1024 (2d Cir. 1986).

215. The four-four split at the Supreme Court, while affirming defendant's conviction, will not be accorded the same stare decisis effect as a holding which is backed by a majority of Justices. As such, the issue of the legitimacy of the misappropriation theory has simply been, once again, put off "for another day." *See Chiarella v. United States*, 445 U.S. 222, 238 (1980).

216. Winan's co-conspirators included Kenneth P. Felis, a stockbroker at Kidder Peabody, Peter Brant, another Kidder stockbroker who later became a government witness, and David Carpenter who served primarily as a messenger between the conspirators. *Carpenter*, 791 F.2d at 1026.

mation and taking a point of view with respect to investment.²¹⁷ The official policy and practice of *The Wall Street Journal* was that prior to publication, the contents of the column were confidential information of the *Journal* itself. Winans, aware of this policy²¹⁸ nevertheless traded on the "probable impact of the column on the market."²¹⁹ Over a four month period the prepublication trading of the conspirators netted about \$690,000.

Carpenter is distinguishable from the cases discussed above in a number of respects. First, *Carpenter* did not involve confidential information of the corporations involved. The information misappropriated by Winans was given to him by the corporations or developed by him to be used for the public purpose of publication in *The Wall Street Journal*. The Second Circuit held, notwithstanding, that no breach of duty to the companies supplying Winans with the misappropriated information was found, "it is sufficient that the fraud was committed upon Winans' employer."²²⁰ In *Carpenter*, there was no specific finding that investors had been harmed; rather, the court stated that "[w]e can deduce reasonably that those who purchased or sold securities without the misappropriated information would not have purchased or sold, at least at the transaction prices, had they had the benefit of that information."²²¹

217. The district court found that the conspiracy did not affect the subject matter or quality of Winan's columns, since "[m]aintaining the journalistic purity of the column was actually consistent with the goals of the conspirators," given that the predictability of the columns' market impact depended in large part on the perceived quality and integrity of the columns." *United States v. Winans*, 612 F. Supp. 827, 835 n.4 (D.C.N.Y. 1985).

218. *Carpenter*, 108 S. Ct. at 319. Winan was found to have been aware of his employer's policy of confidentiality. *Id.* Whether the existence of a policy of confidentiality or the subjective awareness of such a policy on the part of the "misappropriating employee" should have significance for the imposition of 10(b) liability is discussed *supra* at note 190.

219. It is undisputed that the contents of the *Heard* column produced a dramatic impact in the market. The Second Circuit stated:

[T]he 'Heard' columns had [an] undisputed significant market impact; that after the first attempt at profits Winans and Felis recognized that profits would be reaped if trades were made on the basis of analyses of *particular* securities (rather than of general industries) to be published in forthcoming columns, . . . that generally, 'transactions were closed on the same day as an article's publication, thereby maximizing its impact,' . . . and that, once the mature scheme was in operation, net profits therefrom approached \$690,000 over several months. . . . Indeed, the prices of the twenty-nine stocks traded often changed significantly, sometimes even dramatically, between the closing prices the day before publications and the opening prices at 10:00 a.m. on the day of the publications.

United States v. Carpenter, 791 F.2d 1024, 1032 n.9 (2d Cir. 1986) (emphasis in original).

220. 791 F.2d at 1032.

221. *Id.*

Carpenter, like *Newman*, identified almost as an afterthought, impact on the market and unfairness to investors as an effect of the improper use of the nonpublic information.²²² The Second Circuit, in *Carpenter*, stated that impact on the market follows necessarily from the improper use of information. For this reason, the central issue for a theory which makes market impact the index of the duty owed is to determine how much impact should be required before a fiduciary duty is imposed.²²³

Carpenter did not rely on the actual impact the inside trading had on the market to establish Section 10(b) liability, but rather ultimately decided the case on the basis of *The Wall Street Journal's* formal policy of confidentiality. Yet as one commentator has noted, "To decide the case on whether the *Journal* had a formal policy or not is thus hairsplitting of the highest order."²²⁴ By relying solely on the effect of the misappropriator's trading on *The Wall Street Journal's* reputation, the misappropriation theory in *Carpenter* unfortunately attenuated an already shaky relationship between the misappropriation theory and the fundamental purpose of the securities laws, the protection of investors in the market.

The relevance of market impact to the issue of duty was discussed in a context similar to *Carpenter* in *Zweig v. Hearst Corp.*,²²⁵ a Ninth Circuit case involving a financial columnist for *The Los Angeles Herald-Examiner* (*Examiner*). Alex Campbell purchased shares in American Systems Inc. (ASI) prior to authoring and publishing a highly favorable description of ASI in the *Examiner*, which caused the price of ASI stock to rise dramatically. Also prior to publication, Reading Guidance Center (RGC) had entered into a reorganization agreement with ASI. The terms of this agreement involved payment by ASI of ASI stock worth \$1,800,000 to RGC, the price per share to be determined by the average closing bid price for ASI stock from June 5, 1969 to June 10, 1969. Naturally, the higher the price per

222. *Id.*

223. See *infra* notes 252-60.

224. Shapiro, *supra* note 177, at 270; see also *Misappropriation Theory*, *supra* note 180: [C]onditioning the employee's breach on whether the employer has a policy that prohibits employee use of confidential information and whether that policy was communicated to the employee . . . leads to anomalous result[s] when no policy forbidding the trading exists, since the misappropriator may then trade with impunity from possible securities law violations even though he has used what the Second Circuit has deemed a forbidden informational advantage when prohibited by the employer.

Id. at 108 (citations omitted).

225. 594 F.2d 1261 (9th Cir. 1979).

share of ASI, the fewer shares RGC would receive in the reorganization.²²⁶

Zweig, a shareholder in RGC, argued that Campbell had violated Section 10(b) and Rule 10b-5 by virtue of (1) his omission of certain material facts including his own pre-publication investment and his intent to sell on the short swing price rise, (2) that he made a practice of scalping²²⁷ and (3) that his favorable columns were often reprinted as advertisements for subject companies in which Campbell had a financial interest.²²⁸ Zweig claimed that RGC and its shareholders had been harmed since they received fewer shares at an artificially inflated price. The court analyzed the situation as follows:

[A]s a result of Campbell's manipulation of the market, the price of ASI stock rose to an average of \$4.35 per share on the crucial dates prior to the closing of the merger. This meant that instead of receiving more than 540,000 newly issued shares of ASI, RGC received only 413,793. Instead of owning roughly 52 per cent of the combined enterprise, RGC became merely a minority shareholder in ASI. It follows that the ASI shareholders, including Campbell and his readers who bought, came to own nearly 55 per cent of the combined enterprise (by having 500,000 of 913,793 shares) instead of the 48 per cent they would have owned if the market had been free from Campbell's manipulation.²²⁹

The Ninth Circuit held that Rule 10b-5 does cover the activities of a reporter who "uses a column as part of a scheme to manipulate the market and deceive the investing public."²³⁰ The court held that even though Campbell's duty was not a fiduciary duty at common law,²³¹ such a failure to satisfy the common law should not be dispositive of a Rule 10b-5 claim.²³² The court concluded that it was "fully consistent with the spirit and letter of the securities laws to impose upon Campbell a duty to RGC."²³³ Because a purchaser of ASI stock "relied on the free and unmanipulated market that the federal securities laws were designed to foster,"²³⁴ Rule 10b-5 liability could be imposed.²³⁵ Under *Zweig*, therefore, a duty on the part of a financial columnist to refrain from trading on the basis of the

226. *Id.* at 1265.

227. *Id.*

228. *Id.*

229. *Id.* at 1270.

230. *Id.* at 1271.

231. *Id.* at 1270.

232. *Id.* at 1269.

233. *Id.* at 1270.

234. *Id.*

235. *Id.*

probable impact of information to be published runs to the investing public.²³⁶

While *Zweig* has had its supporters²³⁷ and detractors,²³⁸ the assertion by some commentators that the force of *Zweig's* analysis has been undercut by *Chiarella's* reinforcement of common law, historical/categorical analysis of the fiduciary concept²³⁹ is important to the market impact theory which argues a class of investors with no traditional common law fiduciary duty should be held fiduciaries under Rule 10b-5. Because *Zweig* transcends the traditional categories of fiduciaries and finds additional entities potentially liable under Section 10(b), it stands as precedent for the market impact theory. Like *Zweig*, the market impact theory looks to the fraud-on-the market cases as authority to find liability in the Rule 10b-5 con-

236. See Brudney, *supra* note 35, at 369.

237. See Comment, *A Financial Columnist's Liability Under SEC Rule 10b-5*, 10 GOLDEN GATE U.L. REV. 268 (1980).

[T]he extension of an affirmative duty to disclose to a financial columnist seems reasonable owing to the special relationship to the market, and the ability to influence that market. The Ninth Circuit's extension of this affirmative duty to disclose is logical in terms of the purposes behind the securities laws and the courts "flexible" interpretation of them to carry out these purposes.

Id. at 277, 280; Comment, *Testing the Vicarious Liability of a Newspaper Publisher Under 10b-5—Zweig v. Hearst Corp.*, 1975 UTAH L. REV. 740 ("The Ninth Circuit, in *Zweig v. Hearst Corp.*, has helped develop an equitable, consistent, and flexible method for establishing . . . liability under the 1934 Act, which adequately protects the investor while not unreasonably burdening business activity which is not related to the securities markets."). *Id.* at 751.

238. See, e.g., Barry, *supra* note 34, at 1376-80 ("No prior decision had ever imposed on a columnist a duty of disclosure in the absence of explicit statutory command and the Ninth Circuit conceded that Campbell's 'relationship to the public was not a fiduciary one.'") *Id.* at 1376-77 (quoting *Zweig*, 594 F.2d at 1269); Note, *A Financial Columnist's Duty to the Market Under Rule 10b-5: Civil Damages for Trading on a Misleading Investment Recommendation*, 26 WAYNE L. REV. 1021, 1031 (1980) [hereinafter *Columnist's Duty*] ("No precedent exists for the court's extension of a fiduciary duty of disclosure to an unlimited class, the reading-investing public, with whom defendant has not even a contractual or agency relationship."). *Id.* at 1031; Note, *The Ninth Circuit Expands the 10b-5 Net to Catch a Columnist—Zweig v. Hearst Corporation*, 29 DE PAUL L. REV. 287, 294 (1979) ("the [court's] decision must be viewed skeptically since it was the product of a questionable interpretation of the elements of a 10b-5 cause of action."). *Id.* at 294.

239. See, e.g., Note, *Misappropriation Theory*, *supra* note 180, at 101 n.90 ("The viability of the *Zweig* holding . . . has been seriously undercut by the Supreme Court's reinforcement of common law fiduciary relationship principles in *Chiarella*."); see also Seligman, *supra* note 30. "The court analogized the columnist to a 'quasi-insider,' a concept defined by the ALI Federal Securities Code to include persons such as judges' clerks who trade on information in unpublished opinions . . . and to securities marketmakers who are obligated to disclose conflicting interests." *Id.* at 1125.

text without the presence of a traditional, common law fiduciary duty.²⁴⁰

Zweig cited *Affiliated Ute Citizens of Utah v. United States*²⁴¹ for the proposition that while columnists ordinarily have no duty to disclose facts about their personal financial affairs, there are still instances in which Section 10(b) and Rule 10b-5 require disclosure.²⁴² Because proof was offered that the column written by Campbell "initiated many of the stock transactions that caused the quick rise in the stock's price,"²⁴³ the Court, citing *White v. Abrams*,²⁴⁴ found that "Campbell's duty to his readers [was] well established."²⁴⁵ Zweig held that Campbell's having a nontraditional fiduciary duty was the result of his being in a certain professional position which allowed him to significantly influence the market. Liability was found in *Zweig* because Campbell did influence the market by virtue of an abuse of his position. *Zweig*, however, never attempted to articulate precise conditions under which a particular trader, abusing his professional position in the securities context, would come under a nontraditional fiduciary duty to other traders in the market. For this reason, *Zweig* has rightly been criticized as providing an "expansive and open-ended conception of 10b-5 liability [which] should be viewed as inimical to the position evidenced in recent Supreme Court opinions."²⁴⁶

Zweig's reliance on *Affiliated Ute Citizens* and the Ninth Circuit's explicit discussion of the impact of Campbell's actions on the market, however, suggest that *Zweig* was not simply concerned with limiting the ability of persons with special access to confidential information to exploit their position for personal gain. Rather, it suggests an underlying concern with the capability of individuals in special

240. Seligman suggests that "Justice Powell in *Chiarella* may have chosen the reference to Section 551 of the Restatement Second of Torts to signify that he meant the term fiduciary to have a broader meaning than that usually employed in corporate law." See Seligman, *supra* note 30, at 1126. Seligman argues extension of the *Chiarella* duty in *Dirks v. Securities and Exchange Commission*, 463 U.S. 646 (1983), may at least extend fiduciary duties to employees or agents. *Id.* It seems unlikely that the Court would chose to expand the fiduciary concept in a way so obscure while obviously aware that the impact of *Chiarella* would be to bring to the fore the fiduciary concept in Section 10(b) analysis.

241. 406 U.S. 128 (1972).

242. *Zweig v. Hearst Corp.*, 594 F.2d 1261 (9th Cir. 1979).

243. *Id.* at 1269.

244. *Id.* (citing *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974)).

245. *Id.* at 1269.

246. Note, *The Ninth Circuit Expands the 10b-5 Net to Catch a Columnist—Zweig v. Hearst Corporation*, *supra* note 237, at 309; see also *supra* note 154 and cases cited therein for examples and discussion of the Supreme Court's relatively recent, restrictive approach to Rule 10b-5 analysis; see also *supra* notes 149-53 and accompanying text.

positions to influence the market itself. Unfortunately, *Zweig* provided at best an intuitive standard for determining which professional positions could give rise to a finding of fiduciary duty.²⁴⁷ The court never discussed or attempted to quantify the level of impact a trader would have to exercise on the market to justify imposing on him a fiduciary duty. Had *Zweig* considered or ultimately articulated such a standard, the decision might not have been susceptible to the criticism of allowing open-ended Rule 10b-5 liability.²⁴⁸

The most serious conceptual difficulty involved in applying the misappropriation theory as a theory of Rule 10b-5 liability is its lack of connection to the integrity of the market. Though it can be argued that application of the misappropriation theory makes securities related misconduct less likely, the Second Circuit, by denying standing to civil plaintiffs, has undermined the primary policy justification for applying the theory, the deterrence of securities fraud. What the Second Circuit has done is to provide a theory under which relatively insignificant breaches of employment contracts become actionable securities fraud under Rule 10b-5, notwithstanding the sufficiency of common law remedies to deal with such breaches and notwithstanding a lack of precedent to so widely apply Rule 10b-5.

Though the inadequacy of *Chiarella's* common law fiduciary analysis has created the need to develop and apply alternative theories of Rule 10b-5 liability, new theories should reflect a sensitivity to the most fundamental concern of the securities laws, the fostering of a market in which investors will have confidence. Since case analysis under the misappropriation theory denies standing to investors in civil damage actions while failing to make the integrity of the mar-

247. This standard is "intuitive" insofar as it appeals not to a quantified set of objective determinants, but rather to general and unsystematic subjective reflections such as the well known impact financial columns have on the market. Part IV of this note articulates a number of potential measures of market impact, any one of which is sufficient to meet due process considerations of notice to particular investors as to their liability under a market impact theory.

248. Reliance on the disclosure policy underlying *Affiliated Ute* has been cited as the reason that *Zweig* failed to find liability based on economic harm "suffered as a result of a change in market conditions that directly affected the exchange ratio of an executory merger agreement and that was caused by defendant's deceptive purchase recommendation." Note, *Columnist's Duty*, *supra* note 238. Because artificial price inflation has been a primary legislative concern, *id.* at 1024 (citing S. REP. NO. 792, 73d Cong., 2d Sess. 3, 4 (1934)), and because artificial inflation of the market price of securities has been deemed actionable, *Siegel v. Realty Equities Corp.*, 54 F.R.D. 420, 425 (S.D.N.Y. 1972) "[A] jury might find it reasonably foreseeable that such inflated prices would induce the public to purchase . . . stock, and subsequently to suffer damages." The court in *Zweig* unfortunately missed an opportunity to articulate a standard of Rule 10b-5 liability consistent with the economic interests underlying the securities laws.

ket a focal point of inquiry, the positive market related effects of the misappropriation theory are rendered incidental to the protection of the employer-employee contractual relation. This has never been the object of the securities laws. Other theories more reflective of the actual concerns of the Exchange Act must be developed.

PART IV

The market impact theory asserts that those investors who trade on the basis of nonpublic information in such volume as to significantly affect the value of securities in the market should be treated as fiduciaries for purposes of Rule 10b-5 liability.²⁴⁹ Since, theoretically, every purchase or sale of a security impacts on the market to some degree, a theory of Rule 10b-5 liability which relies on the concept of significant impact must specify the level or amount of trading which will be a sufficient condition for the imposition of a fiduciary duty.²⁵⁰ Discussed below are three different standards which could be applied to determine whether the trading of a particular investor had so significant an impact on the market that he should be treated as a fiduciary for purposes of imposition of Rule 10b-5 liability. It is suggested that adoption by either courts or the legislature of any of these standards would provide adequate notice to investors as to when the effects of their trading would subject them to potential Rule 10b-5 liability under the market impact theory.²⁵¹

A. Proposed Standards

The first suggested standard adapts relevant portions of Section 16(b) of the Exchange Act.²⁵² Section 16(b) of the Exchange Act,

249. Though Part I of this Note discussed only the role of risk arbitrageurs in the financing of large corporate transactions, Part IV discusses the role of institutional traders, who, like risk arbitrageurs, exert a tremendous influence in the market.

250. This must be the case since the class of traders picked out by the market impact theory is determinable on the basis of the level of impact their trading has on the market.

251. If the concept of significant impact were not quantified, the ready defense of investors would be that the market impact theory did not comport with the Constitutional requirements of due process or the basic interest of fairness which plays so important a role in the Exchange Act. Investors must be able to know when their activities will breach a duty in order to make the imposition of 10b-5 liability justifiable.

252. Section 16(b) of the Exchange Act provides, in relevant part:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer . . . within any period of less than six months,

like Rule 10b-5, was designed to minimize the unfair use of inside information.²⁵³ It provides that any profit, by any person subject to the reporting requirements of Section 16(a),²⁵⁴ who realizes on the purchase and sale or sale and purchase, of any non-exempt equity security of an issuer that has an equity security registered under the Exchange Act, within any period less than six months, shall "inure to and be recoverable by the issuer." Section 16(b), unlike Rule 10b-5, does not make "short-swing trading illegal."²⁵⁵ Instead, 16(b) provides that within the specified time frame, profits from certain securities transactions belong to the issuer and are recoverable either by him or by any security holder of the issuer suing derivatively.

Because Section 16(b) was meant to function as a deterrent to the misuse of nonpublic information by persons in special positions of access to such information, the ten percent standard built into Section 16(b) provides a potential standard under which persons will become fiduciaries under Rule 10b-5, which seeks to realize similar if not identical policy goals.²⁵⁶ Since the ten percent standard is al-

unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

15 U.S.C. § 78p(6) (1983).

253. L. SODERQUIST, *UNDERSTANDING THE SECURITIES LAWS* 273 (1987).

254. Section 16(a) provides:

Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 781 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national securities exchange or by the effective date of a registration statement filed pursuant to section 781(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission . . . of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission . . . , a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

15 U.S.C. § 78p(a) (1983)

255. See L. SODERQUIST, *supra* note 253, at 274.

256. The deterrent policies underlying 16(b) and Rule 10b-5 cover different classes of investors. Rule 10b-5 is primarily aimed at any investor who uses nonpublic information in a breach of a fiduciary duty to perpetrate a fraud, while 16(b) imposes absolute liability on any officer, director or ten percent beneficial owner of securities engaging in short-swing trading. That non-identical classes of investors are targeted by Rule 10b-5 and 16(b) provides no theoretical reason why the percentage specified in 16(b) should not be adapted to provide a standard under which to realize the shared goal of preventing the improper use of nonpublic information in the market. The ten percent standard of 16(b) would be an appropriate measure since a ten percent acquisition is a dramatic investment. See S.E.C., *INSTITUTIONAL INVESTOR STUDY*

ready associated in this context with the deterrent policies of the Exchange Act, it is a natural extension to use this same percentage as a means of establishing a necessary condition for the finding of civil and/or criminal liability under Rule 10b-5.

The first proposed standard under which an individual could be treated as a fiduciary with respect to a transaction involving a particular security issue under Rule 10b-5 would be:

If an individual, subject to the reporting requirements of Section 16(a) of the Exchange Act, purchases and sells or sells and purchases more than ten percent of the outstanding shares of a particular class of equity securities registered under the Exchange Act, that individual shall be treated as a fiduciary for purposes of the imposition of Rule 10b-5 liability with respect to any and all transactions involving that class of securities, since trading such percentage of shares will be presumed to create an impact within the market, sufficient to justify imposition of such a duty.

A second, stricter standard could be articulated by adapting the reporting requirements of Section 13(d) of the Exchange Act.²⁵⁷ Section 13(d) in relevant part states:

Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to Section 78L of this title . . . is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition . . . file with the Commission, a statement containing such of the following information, and such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors. . . .²⁵⁸

Either the five per cent standard, or the ten per cent standard discussed above, is workable because ownership of a specified percentage of securities is determinable. Since the standard set under Section 13(d) is precise, any investor should know when he must report. Similarly, using the same determinate percentage should serve the public interest by clarifying who has a fiduciary duty under Rule 10b-5. An adaptation of the Section 13(d)'s five per cent standard might be articulated as follows:

If a person purchases or sells more than 5 percent of an equity security of a class which is registered under Section 12 of Title 15, such

REPORT, H.R. REP. NO. 64, 92d Cong., 1st Sess. 2831 (1971) (hereinafter *INVESTOR STUDY*) ("[I]t would be disingenuous to suggest that a purchase of up to 10 percent of another company's stock is merely a routine 'investment' . . .").

257. 15 U.S.C. § 78m(d)(1).

258. *Id.*

person will be treated as a fiduciary for purposes of the imposition of Rule 10b-5 liability with respect to any and all transactions involving that security.

A standard of imposition of fiduciary duty which makes use of the Section 13(d) five percent standard would obviously be a stricter standard than one incorporating the ten percent standard of Section 16(b). Either standard, however, would be historically and analytically related to the protection of investors and the public interest. Further, while there may be questions as to whether a private right of action exists for violations of the reporting requirements under Section 13(d),²⁵⁹ no such question would arise with respect to violation of a fiduciary duty defined by the Section 13(d) percentage. Since the 13(d) percentage is used solely to determine who are fiduciaries for purposes of the imposition of Rule 10b-5 liability, the issue of whether a private right of action exists will be determined exclusively with reference to case law construing Rule 10b-5.²⁶⁰ The 13(d) concept of direct or indirect acquisition is replaced, however, by the 16(b) concept of purchase or sale so as to focus attention on the impact which sales, as well as mere acquisitions, have on the market.

A third method for specifying impact sufficient to justify the imposition of a higher duty on an investor would be to articulate a certain dollar amount traded over a specified period of time. If trader X purchased or sold securities valued at say twenty million dollars over a period of six months, and trading of such an amount was deemed sufficient to significantly impact on the market as a whole, trader X could be held to be a fiduciary of the market as a whole regardless of whether he traded specified percentages in par-

259. See, e.g., *Liberty Nat'l Ins. Holding Co. v. Charter Co.*, 734 F.2d 545 (11th Cir. 1984) (holding no private right of action under Section 13(d)) "[C]ritical examination of the legislative history [of 13(d)] does not . . . permit an unambiguous inference of legislative intent to preserve a judicially recognized . . . right of action." *Id.* at 562-63; *Leff v. CIP Corp.*, 540 F. Supp. 857, 864 (S.D. Ohio 1982) (legislative history silent on any private right of action); *Gateway Indus. v. Agency Rent-A-Car*, 495 F. Supp. 92 (N.D. Ill. 1980); *Sta-Rite Indus., Inc. v. Nortek, Inc.*, 494 F. Supp. 358 (E.D. Wis. 1980); *Berman v. Metzger* (1981 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 97,857, at 90,293 (Feb. 9, 1981); see also L. SODERQUIST, *supra* note 253, at 239-40.

260. Since the market impact theory asserts that a fiduciary duty is *directly* owed to each shareholder injured by the fiduciary's trading, a private right of action to seek civil damages exists in each injured shareholder. Even though the status of having a fiduciary duty is defined by a level of market impact generated by the trading of the alleged wrongdoer, and the sufficiency of the impact is itself defined under this second, potential standard by direct or indirect acquisition of the same percentage of shares as creates a duty to report under 13(d), it is not 13(d) liability that is generated under the market impact theory, but rather Rule 10b-5 liability.

ticular securities. While the twenty million dollars figure is a somewhat arbitrary amount mentioned for paradigmatic purposes, this figure could actually be used as the benchmark for the imposition of fiduciary duty under Rule 10b-5.

B. Pre-tender Offer Stock Accumulation

The effect of using market impact as a means of determining additional individuals held to be fiduciaries under Rule 10b-5 would have a staggering impact on the use of nonpublic information by risk arbitrageurs and institutional investors. Because these traders are often intimately involved in the financing of major market transactions including tender offers,²⁶¹ and because virtually every tender offer requires financing,²⁶² the possibility of Rule 10b-5 liability where arbitrageurs and institutional traders purchase stock on the basis of nonpublic information would seriously impede the present mode of financing large numbers of current market transactions.²⁶³ However, to continue insulating risk arbitrageurs and institutional traders from Rule 10b-5 liability virtually guarantees that the routine exploitation of nonpublic information by a handful of investors will continue to disadvantage all other traders in the market.

The problem of continuing to allow large institutional traders special privileges with respect to market transactions was discussed in an Institutional Investor Study conducted in 1971 by the SEC. The summary volume to the Study stated:

With respect, however, to passing on information about a prospective takeover effort to favored institutions, the persons who do so usually are the persons who plan the takeovers and ordinarily have no relationship to the target company, nor do they usually have any fiduciary duty to that company or its shareholders. This difference in relationships does not necessarily mean that such passing on of information concerning takeovers should be permitted²⁶⁴

261. INVESTOR STUDY, *supra* note 256, at 2836.

Such financing may . . . take the form of special arrangements with institutional investors that facilitate the transfer bid. Thus, institutions may purchase the bidder's securities in a private offering, the purpose of which is to raise enough money for the bidder to purchase an initial block of the target's shares [I]t may arrange for institutions to serve as conduits or 'warehouses' (in industry jargon)—purchasing the shares and holding them for some specified period until the bidder is able to purchase the shares itself. . . .

Id.

262. *Id.*

263. See *supra* notes 39-40 and accompanying text.

264. INVESTOR STUDY [Summary Volume], *supra* note 256, at XXXII; see *supra* note 253; see also *infra* notes 268-76 and accompanying text.

The report itself stated:

To the extent that certain institutional investors might have been given non-public information about the intention of a bidding company to embark upon a program of acquisitions, those investors might have violated Rule 10b-5 by purchasing the bidding company's stock in anticipation of the public announcement of such a program.²⁶⁵

Though the Institutional Investor Study suggests that a possible violation of Rule 10b-5 may occur in the abovementioned situation, it nowhere explains in theoretical terms why such a violation may have occurred. A market impact analysis provides a justification for the imposition of Rule 10b-5 liability in this context. The use of non-public information by institutional traders has a tremendous effect on the market.²⁶⁶ Further, large institutional investors have been found by the Institutional Investor Study to have the following special benefits:

- (1) Advance information that a takeover effort will be made (permitting the institution to make purchases of the bidding company or target company securities before the market impact of a publicly announced tender offer has affected the price of the securities involved).
- (2) Most-favored shareholder provisions, under which institutions selling an initial block of the target's shares to the bidding company have the right to receive any higher price subsequently offered to all shareholders of the target company through a public tender or exchange offer.
- (3) Assurances of contingent benefits (sometimes available only if the transfer bid succeeds), such as management of the target company's investment portfolio or commercial banking arrangements with the bidding or target company.²⁶⁷

265. INVESTOR STUDY, *supra* note 256, at 2830. Ultimately, the Commission determined that passing of information to institutional investors should not be permitted, but asserted that its prohibition "should be done by a rule specifically directed to that situation rather than by an expanded interpretation of Rule 10b-5 . . ." *Id.* [Summary Volume], at XXXII. The rule adopted by the Commission is Rule 14e-3 which is discussed *infra* at notes 282-99 and accompanying text.

266. INVESTOR STUDY, *supra* note 256, at 2843, 2845, 2847.

[I]nstitutions, because of the size of their holdings, can have greater influence over portfolio companies than can the average individual investor . . . [L]arge institutions, particularly banks, have the potential economic power to exert significant influence over many companies whose securities comprise their portfolios, particularly large companies . . . [I]nstitutions may obtain advantages not available to the individual investor. Such participation involves . . . the use of information not generally available to investors which are obtainable by institutions because of the recognition by all parties . . . of the economic power of institutions to influence the outcome of the contest.

Id.; see also *supra* notes 39-40 and accompanying text.

267. *Id.* at 2848.

In the early 1970's, one of the few commentators to devote an article to the practice of warehousing, discussed the possibility of Rule 10b-5 liability in a large mutual fund which warehoused stock in anticipation of corporate takeovers. The author, E. B. Thomas stated:

Under usual concepts, the potential acquiring company and its allies would not be insiders vis-a-vis the shareholders of the target company, and there would be no duty of disclosure. Nevertheless, information about an impending cash tender or exchange offer is of such great importance to shareholders of the target company that it may ultimately be established that there is a duty to disclose in this situation . . . as long as the potential acquiring company is acting by itself in acquiring shares of a potential target company, it has no duty to disclose its intention to others, but once it elects to make known its plans to others, neither they nor the acquiring company may make further purchases without disclosing the acquiring company's intentions.²⁶⁸

Thomas made clear that even though there might not be a fiduciary or quasi-fiduciary relationship between a mutual fund and the target corporation, the importance of the mutual funds role vis-a-vis the shareholders of the target corporation in financing the takeover could justify the imposition of Rule 10b-5 liability.²⁶⁹ Thomas, when referring to fiduciary duty, was speaking in traditional common law terms rejected as inadequate by this article.²⁷⁰ Still his essay remains relevant to a market impact analysis of the fiduciary concept. It demonstrates that for many years commentators have been aware that strong policy considerations suggest large investors, because of the uniqueness and importance of their role in financing certain corporate transactions, should be subject to Rule 10b-5 liability when they trade on the basis of nonpublic information.

When large traders are given nonpublic information by a company for the express purpose of helping that company successfully realize a specific corporate transaction and use is made of that information to effect purchases or sales which have a significant impact on the market, an improper use of nonpublic information occurs. It is improper because the use of tremendous financial resources to effect massive purchases and sales of stock virtually guarantees that every other investor with whom the large investor transacts will be disadvantaged in terms of material information respecting the affected

268. See Thomas, *Warehousing*, 3 REV. SEC. REG. 975, 977 (1970).

269. *Id.*

270. Thomas did not state that he was speaking in terms of a traditional common law fiduciary duty, but his lack of discussion on the point seems to indicate this was probably the context of his discussion.

transactions. Further, the actual dollar value of shares in the hands of every investor in the market will ultimately be determined by the trading of a handful of wealthy traders. This is the ultimate cost to the market of the use of nonpublic information by institutional traders and the risk arbitrageur.

In response to the position taken by Mr. Thomas above, professors Fleischer, Mundheim, and Murphy, in a well known article which discussed the Institutional Investor Study's findings concerning the warehousing practices of institutional investors, argued that Thomas had not stated a basis for concluding warehousers have a duty to disclose or abstain from trading.²⁷¹ They argued warehousing might serve as "interim financing"²⁷² for potential acquiring companies who could not secure financing by conventional means. Warehousing allowed them "to take advantage of their self-generated analysis that the target's stock may be underpriced."²⁷³

Thomas did, however, provide an explanation for his conclusion, articulated in terms of the importance of the effect of the mutual fund's trading on a class of investors to whom the mutual fund had no traditional common law fiduciary duty, the target corporation shareholders.²⁷⁴ The impact of institutional trading on the market itself provides another explanation. The assertion that warehousing is simply an alternative means of interim financing is unconvincing. Not all means of financing involve either the exploitation of material nonpublic information to the detriment of smaller investors or have a dramatic impact on the value of the stock holdings of smaller investors. To liken stock warehousing to other forms of financing without making reference to these differences can be extremely misleading, since it equates an activity which is essentially innocuous, traditional forms of interim financing, with one which puts the vast majority of investors in the market at a severe disadvantage.

The practice of warehousing was addressed by Justice Burger's dissent in *Chiarella*.²⁷⁵ After noting that the antifraud provisions of the securities laws were designed in large measure to assure that dealings in securities were "fair and without undue preferences or

271. See Fleischer, *supra* note 35, at 814.

272. *Id.*

273. *Id.* at 814-15.

274. Thomas, *supra* note 268, at 977.

275. *Chiarella v. United States*, 445 U.S. 242 (1980). No detailed discussion of the practice of warehousing was included in the majority's opinion. Justice Powell, did, however, note "[T]he Commission has acted to bar warehousing under its authority to regulate tender offers" *Id.* at 234.

advantages among investors,"²⁷⁶ Burger stated his reading of Section 10(b) and Rule 10b-5 would not proscribe warehousing or other "legitimate business practices."²⁷⁷ However, Burger did not state why warehousing was a legitimate business practice; a curious omission since warehousing obviously involves preferences and advantages for a few wealthy traders. Burger did criticize the investor who purchases securities on the basis of misappropriated nonpublic information as possessing an undue trading advantage, and noting that such conduct "serves no useful function except [the trader's] own enrichment at the expense of others."²⁷⁸ It is unclear why Burger considered the activity of risk arbitrageurs and institutional investors, trading on the basis of nonpublic information, and serving the interests of a mere handful of investors, a legitimate business practice rather than an undue trading advantage.

Under the majority's analysis, warehousing would not violate Rule 10b-5 because a risk arbitrageur or institutional investor has no traditional common law fiduciary duty to either target shareholders or purchasers or sellers of stock in an impersonal market transaction. Under the misappropriation theory, since the creator and owner of the information permitted its allies to use nonpublic information to make stock purchases for its own benefit, the legitimate owner of the information has not been defrauded. Under this rationale, the misappropriation theory is not violated by the practice of warehousing.²⁷⁹ At any rate, neither *Chiarella's* common law fiduciary analysis nor the Second Circuit's misappropriation theory will sustain a finding of liability in those investors who are actually the greatest exploiters of nonpublic information in the current market.

C. *Pre-Tender Offer Stock Accumulation and Rule 14e-3*

Though Chief Justice Burger did not find warehousing violative of the antifraud provisions, the SEC, believing regulatory action was necessary to prevent powerful institutions from being treated more favorably than individual investors, adopted Rule 14e-3 in 1980, pursuant to power granted it under the 1970 Amendments to the Williams Act.²⁸⁰ Under Rule 14e-3, a corporation seeking to gain con-

276. *Id.* at 241 (citing H.R. CONF. REP. NO. 94-229, p. 91 (1975)).

277. *Id.* at 242.

278. *Id.* at 241.

279. *Id.* at 231-33.

280. The SEC adopted Rule 14e-3 on Oct. 14, 1980. See 45 Fed. Reg. 60,410 (1980). Rule 14e-3(a) states:

trol of a target through a conventional tender offer may not provide information relating to that tender offer to risk arbitrageurs or institutional traders once that tender offer has commenced or where a substantial step has been taken to commence it.²⁸¹ The language of Rule 14e-3, which closely tracks the language of Rule 10b-5,²⁸² however, has created uncertainty with respect to the application of Rule 14e-3 to pre-tender offer stock accumulation.²⁸³ In particular,

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,

(2) The issuer of the securities sought or to be sought by other tender offer, or

(3) Any officer, director, partner or employee or any such person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a)(1988).

281. See Allen, *The Scope of the Disclosure Duty Under SEC Rule 14e-3*, 38 WASH. AND LEE L. REV. 1055, 1060-65 (1981); Gruenbaum, *Acquisitions and Mergers*, 4 CORP. L. REV. 350, 352-55 (1981); Heller, *supra* note 197, at 541-45.

282. The implications of this tracking of language between 10b-5 and 14e-3 are discussed generally in Heller, *supra* note 197, at 542-45; see also Allen, *supra* note 281, at 1061-65; Phillips and Zutz, *The Insider Trading Doctrine: A Need For Legislative Repair*, 13 HOFSTRA L. REV. 65, 95-96 (1984); Strickler, *Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain*, 73 CAL. L. REV. 483, 495 (1985).

283. See Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L. J. 79, 87-88 (1987).

There have long been substantial doubts as to the validity of Rule 14e-3, due to the fact that it attempts to preclude under Section 14(e) conduct that the Supreme Court said could not be precluded under the similar (but not identical) language of Section 10(b). The doubts about Rule 14e-3's validity are now even greater, after the Supreme Court's recent pronouncement that Section 14(e) can regulate only manipulative and deceptive conduct.

Id. at 113 (citing *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985)); Poser, *Stock Market Manipulation and Corporate Control Transactions*, 40 U. MIAMI L. REV. 671 (1986) (The Supreme Court's holding, in *Schreiber*, that the sole purpose of Section 14(e) is disclosure raises a question as to the validity of SEC Rules 14e-1, 14e-2, and 14e-3, which are substantive rules adopted by the Commission under Section 14(e)); Subcommittee on Annual Review, Significant 1985 Court Decisions, 41 BUS. LAW 969 (1986) (It is at least arguable that a proscription on insider trading may not be adopted pursuant to a statute [14(e)] prohibiting disclosures failures.); Heller, *supra* note 197. "[T]he language in Section 10(b) . . . and the prohibition in Section 14(e) . . . [is] in substance identical . . . it is unclear whether the Commission's statutory authority extends to transactions entered into prior to the actual making of a tender offer." *Id.* at 542; see also Gruenbaum, *supra* note 281 (the express language of the statute requires that an actual tender offer must be commenced before a violation can occur). *Id.* at 355.

problems have centered on the Rule 14e-3 phrase “*in connection with a tender offer*” which is grammatically identical to the Rule 10b-5 language “*in connection with the purchase or sale of a security.*” This similarity of syntax suggests that similar construction of the two rules would be appropriate. Since case law has held Rule 10b-5 liability attaches only where fraud occurs close to the actual purchase or sale of the security itself,²⁸⁴ commentators have argued that the phrase “*in connection with a tender offer*” should be judicially limited to activities during the actual making of the tender offer itself.²⁸⁵ For this reason, a number of commentators have concluded that the SEC exceeded its rule making authority under Section 14(e) by adopting a rule broader than the statute which it was intended to implement.²⁸⁶

In a situation where a bidder requests that a risk arbitrageur or institutional trader warehouse stock for eventual tender, it is therefore unclear that liability exists under Rule 14e-3 since no tender offer has been commenced, and arguably, no substantial step toward commencement has taken place. While the pre-tender offer acquisition of shares might in itself constitute a substantial step towards the commencement of a tender offer, Rule 14e-3 requires that the acquisition of securities occur after a substantial step has been taken. Since the pre-tender offer securities acquisition would itself be the substantial step required as a prerequisite to finding liability, it could not simultaneously serve as the violation and the prerequisite to finding a violation. On this basis, one commentator has concluded that if the offering company was aware of the activities of the acquirers of target shares, “it would seem difficult to sustain the proposition that either Section 14(e) or Rule 14e-3 prohibits such activity unless the

284. See, e.g., *Valente v. Pepsi Cola*, 454 F. Supp. 1228, 1236 (D.C. Del. 1948) (“[T]he deceptive practice must ‘touch,’ and exist in as reasonably close proximity to the purchase or sale [of a security]”); see also *Superintendent of Life Ins. v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971); *Ketchum v. Green*, 557 F.2d 1022 (3d Cir. 1977), *cert. denied*, 434 U.S. 940 (1977).

285. See Greenbaum, *supra* note 281, at 355; Heller, *supra* note 197, at 542-43.

286. See Greenbaum, *supra* note 281. (“[14e-3] appear[s] to be broader than the statute which it was intended to implement”) *id.* at 355; Phillips and Zutz, *supra* note 282, at 96. The rules adopted under 14(e) and 10(b) must be directed against fraud. In addition, *Chiarella* emphasizes that a finding of fraud under 10(b) requires a fiduciary relationship. Since the rule making authority under Sections 14(e) and 10(b) is so similarly worded, “[R]ule [14e-3] appears to transgress the SEC’s rulemaking authority granted by Congress in Section 14(e).” *Id.* But see *SEC v. Musella*, 578 F. Supp. 425, 443-44 (S.D.N.Y. 1984); *SEC v. Wallis*, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,562, at 98,845 (May 31, 1984).

Commission adopts a clear-cut egalitarian theory with respect to use of material information about the target company."²⁸⁷

A further problem with use of Rule 14e-3 to restrict use of non-public information is that Rule 14e-3, by its own terms, generates liability only in the tender offer context. Institutional investors and risk arbitrageurs are permitted to engage in all other market transactions free of any Rule 14e-3 constraint on their exploitation of nonpublic information.²⁸⁸ For this reason Rule 14e-3, like Rule 10b-5, is an inadequate mechanism for constraining the behavior of that group of investors who substantially control the value of securities in the market by using nonpublic information.

D. The Insider Trading Proscriptions Act of 1987

On June 17, 1987, Senators Donald W. Riegle and Alfonse M. D'Amato introduced the Insider Trading Proscriptions Act of 1987 (ITPA).²⁸⁹ This proposed legislation, which subsequently failed to pass through the Banking Committee,²⁹⁰ was drafted by a committee

287. Heller, *supra* note 197, at 544. Heller notes that the SEC had sometimes expressed "broad principles which imply the adoption of an egalitarian theory of disclosure to the markets and the public by all holders of undisclosed, material information." *Id.* at 544 n.64. For example, In the Matter of Cady, Roberts and Co., 40 S.E.C. 907 (1961), the SEC stated:

[W]e, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe the alternative is to forgo the transaction.

Id. at 911 (footnote omitted).

288. See Barry, *supra* note 34, at 1373 "Because rule 14e-3 applies only to tender offers subject to the Williams Act, . . . warehousing arrangements should be valid in other contexts under the common law approach."; see also McLucas & DeTore, *A Review of Recent SEC Enforcement Actions Against Members of the Securities Industry Involving Parking, Net Capital and Related Violations*, dated Apr. 8, 1988 (available from the Washington office of the SEC). The author's analysis of recent parking/warehousing cases and schemes demonstrates that recent schemes are "more serious than those the Commission has considered in the past," and that in some recent cases, "brokerage firms charged were not concealing their own net capital deficiencies, but rather [were] assisting or 'accommodating' schemes initiated by another firm to circumvent the net capital rules." *Id.* at 7. Although the recent parking/warehousing schemes "are not merely technical or *de minimis*" and "circumvent . . . significant investor protection," the authors note that "[t]he willingness of established firms to participate in schemes of this magnitude . . . is alarming." *Id.* at 10-11.

289. S. 1380, 100th Cong., 1st Sess., 133 CONG. REC. 8247-48 (1987).

290. Telephone conversation with the offices of the Senate Comm. on Banking, Housing and Urban Affairs (Feb. 15, 1989).

A later SEC draft bill, the Insider Trading Act of 1987, represented a revision of S. 1380, The Insider Trading Proscriptions Act of 1987. *Definition of Insider Trading, Part II, 1987:*

of lawyers whose purpose was to provide a legislative definition and prohibition of the offense of insider trading.²⁹¹ The ITPA, which in large measure was drafted in direct response to public outcry following the Boesky case, was designed to be a precise, plain-English prohibition against insider trading and tipping.²⁹² Because at least part of the impetus behind the legislation was a public perception that the securities markets were unfairly controlled by a small number of privileged, extremely powerful traders and institutions,²⁹³ and since the first legislative finding identified fairness, honesty and market integrity as interests impaired by the wrongful use of material nonpublic information,²⁹⁴ it might naturally be assumed that the proposed legislation would have prohibited the most flagrant and far reaching wrongful uses of nonpublic information. Unfortunately, under the proposed legislation, small investors like Mr. Chiarella would have remained liable under the securities laws for breaches of their employment contracts while the Boeskys of this country, who routinely trade on the basis of nonpublic information, would continue to be insulated from liability under those same laws. The specific anti-tipping provision of the ITPA²⁹⁵ would have "prevent[ed] the practice

Hearings on S-1035 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. 155 (1987)(statement of Charles C. Cox, Acting Chairman, SEC).

291. The Securities and Exchange Commission and the New York Stock Exchange also submitted proposed definitions of insider trading to the Committee drafting the Act. *See Securities and Exchange Commission Proposed Legislation "The Insider Trading Act of 1987"* and Memorandum of Support Submitted to the Subcommittee on Securities U.S. Senate, Aug. 7, 1987, 19 Sec. Reg. & L. Rep. (BNA) No. 33, 1284 (Aug. 14, 1987); Report of the New York Stock Exchange Legal Advisory Committee, Proposed Statutory Definition of Insider Trading, June 30, 1987. These proposed legislative definitions were analyzed in a joint written statement by Harvey L. Pitt, Theodore A. Levine and John F. Olson before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee regarding S. 1380, dated Aug. 7, 1987 [hereinafter Joint Statement].

292. Pitt & Shapiro, *New Act May Help Clarify Law*, N.Y.L.J., July 27, 1987, at 21, col. 6 (Comments of Harvey Pitt and Karen L. Shapiro, members of the committee which has drafted S-1380, the Insider Trading Proscriptions Act of 1987, 100th Cong., 1st Sess., 133 CONG. REC. S8247-48 (1987)).

293. *See* Joint Statement *supra* note 291, at 2.

294. A cursory examination of articles on the front pages of The Wall Street Journal and New York Times in the weeks following the Nov. 14, 1986 disclosure of the Boesky affair support this conclusion.

295. An exception built directly into Section 16A(C)(2) of the ITPA stated:

It shall be unlawful for any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person (herein the 'transacting person'), for the purpose of influencing or encouraging the purchase or sale of the securities of such issuer, to communicate, directly or indirectly, material, nonpublic information concerning such plans to any other person who thereafter purchases or sells the affected securities unless such other person is act-

of 'tipping' material, nonpublic information to market professionals by any person contemplating any extraordinary corporate transaction involving a public company, for the purpose of influencing or encouraging transactions in the affected securities."²⁹⁶ However, it would not have rendered a practice such as warehousing, (which is at least theoretically illegal in the context of tender offers under Rule 14e-3),²⁹⁷ illegal in the context of other market transactions, despite the fact that other traders would be injured in precisely the same way as in the tender offer context.²⁹⁸

Acting Chairman of the Securities and Exchange Commission, Charles C. Cox, testified in response to the proposed legislation, that the ITPA "in large part, codif[ies] existing law."²⁹⁹ The approach to the definition of wrongful trading combines the concept of misappropriation with "certain aspects of the breach-of-duty analysis that have emerged from insider trading case law."³⁰⁰ Information is wrongfully used or obtained under the ITPA "only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence."³⁰¹ Three problems are apparent.

First, wrongful conduct was partly defined by the ITPA in terms of fiduciary relationships but no analysis of the fiduciary concept was contained in the language of the act. This failure to articulate meaningful criteria by which to determine which individuals are fiduciaries for purposes of imposition of insider trading liability perpetuates

ing on behalf of or as part of a group with the transacting person (within the meaning of Section 13(d)(3) of this title) or the communication of such information has been made in the course of a good faith solicitation of such other person to act on behalf of or as part of a group with the transacting person (within the meaning of Section 13(d)(3) of this title) or the securities are acquired directly from or sold directly to the transacting person.

S. 1380, 100th Cong., 1st Sess., 133 CONG. REC. 8248 (1987).

296. Joint Statement, *supra* note 291, at 13-14.

297. See *supra* notes 249-57 and accompanying text.

298. The same disadvantages with respect to available information, cost structure and resources would ultimately result in a monetary loss to investors whether they were disadvantaged during a takeover or other market transaction. See *supra* notes 20, 39, 40, and especially 267 and accompanying text. A detailed analysis that identifies which investors may be harmed, and how they may be harmed is contained in Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1234-45 (1981).

299. See *Hearings on S. 1380 Before the Subcomm. on Securities of the Senate Banking Housing and Urban Affairs Comm.*, 100th Cong., 1st Sess. 6 (1987).

300. Joint Statement, *supra* note 291, at 10.

301. See S.1380, 100th Cong., 1st Sess. § 16A(b)(1), 133 CONG. REC. S 8247-48 (1987).

exactly the same analytical problem as was posed by *Chiarella*, at least regarding those who would be liable under the ITPA as fiduciaries. Second, making breaches of contractual or employment relationships a basis on which to predicate liability under the securities laws has been sharply criticized by commentators in the context of the misappropriation theory as being inconsistent with the securities laws proper focus on the market itself.³⁰² Finally, Section 16A(b)(1)'s simplistic codification of existing case law³⁰³ generates the following absurd conclusion: a small investor like *Chiarella*, whose trading on the basis of material, nonpublic information in the context of tender offer, which had virtually no effect on the market, would be liable under the ITPA since he violated his employment contract with his employer. Yet a risk arbitrageur like Ivan Boesky, whose trading on the basis of material, nonpublic information was predicated on the staggering impact his trading would have on the market, would have no liability since under extant case law, risk arbitrageurs are not fiduciaries for purposes of Rule 10b-5, and further, their warehousing agreements are normally not breaches of contractual employment relations.³⁰⁴ Thus, even if the ITPA had been enacted, it would not have represented a meaningful or appropriate response to the changed conditions of the contemporary securities market.³⁰⁵

302. See *supra* notes 146-70 and accompanying text.

303. Mitchell, *Insider Trading-The Easy Way Out*, N.Y.L.J., Aug. 6, 1987, at 2, col. 3 (The Insider Trading Proscriptions Act of 1987 does nothing more than to codify existing judge-made law, while undercutting its common-law logic, and to provide for statutory remedies.).

304. Perhaps this outcome is thought to be innocuous since Rule 14c-3 is supposed to control the use of nonpublic information in the tender offer context. The arguments above, however, indicate there are serious problems which may preclude application of Rule 14c-3 to tender offer stock accumulations, and warehousing in non-tender offer contexts is not precluded by Rule 14c-3. See Barry, *supra* note 34, at 1373 ("Because Rule 14c-3 applies only to tender offers subject to the Williams Act . . . warehousing arrangements should be valid in other contexts under the common law approach."); see also McLucas & DeTore, *supra* note 288 (discussion of various parking/warehousing schemes and the importance of not treating them as mere technical violations).

305. Congress did pass the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1989). The Act was in response to continuing "market abuses" and the need to restore the public's confidence "in the fairness and integrity of our securities markets." H.R. REP. NO. 910, 100th Cong., 2d Sess. § 7, reprinted in 1989 U.S. CODE CONG. & ADMIN. NEWS 6043, 6044. However, there was no attempt to analyze the fiduciary concept, and while the drafters recognized the importance of establishing clear guidelines as to what behavior constitutes insider trading, a statutory definition was not included. See *id.* at 11. The Energy and Commerce Committee put forth several reasons for its exclusion. First was the belief that current case law, such as *Chiarella*, has already delineated guidelines for the "vast majority of traditional insider trading cases." *Id.* (emphasis added).

CONCLUSION

The law regarding insider trading today allows the routine use of nonpublic information by large traders, notwithstanding Rule 10b-5, the misappropriation theory, Rule 14e-3, and attempts at legislative reform. It is urged that a different approach to insider trading liability is appropriate since the continued insulation of large traders from liability under the securities laws undermines confidence in the integrity of the market exemplifying and establishing what many investors already believe, namely, that a small number of traders are actually controlling the value of securities in the market and the market itself.

*Laurence A. Steckman**

The Committee feared that statutory definition could be potentially restrictive and inadvertently "facilitate schemes to evade the law." *Id.* Second, the Committee believed that the purposes of the Act, "to provide greater deterrence, detection and punishment of violations," could be effectuated despite disagreement over the parameters of insider trading. *Id.* The standards adopted do nothing to address the inequities that arise under current case law when applied to the *Chiarella* and *Boesky*-type situations suggested in the text. In essence the Act is sanction oriented. It increases jail sentences and fines for those convicted of violations and initiates a bounty program rewarding informants. *Id.* at 7.

* This note was written while the author was a student at Touro Law School. He has since graduated, and now practices law in New York.