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Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws

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I. INTRODUCTION

The upsurge in securities fraud cases, especially those involving insider trading, has subjected the federal securities laws to political debate, ethical examination, and perhaps most startlingly, intense media attention.[1] The term "inside information" is now common parlance beyond the context of securities trading to describe situations in which previously undisclosed information is used to gain an unfair transactional or tactical advantage.[2]

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1. *See, e.g., Wall Street* (20th Century Fox 1987).

2. The term "insider trading" is a misnomer because it applies to trading by persons who are not insiders of the corporate issuer. "Inside information" does not necessarily relate to the internal operations or prospects of the corporation. Committee 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*, 41 BUS. LAW. 223, 224 (1985) [hereinafter *Task Force Report*].

Section 16 of the Securities Exchange Act of 1934 is the only provision that specifically

Despite the attention given to insider trading, there is little consensus as to the meaning of the term. "Insider trading" is not defined in the two major federal acts regulating securities transactions, the Securities Act of 1933[3] and the Securities Exchange Act of 1934 (Exchange Act).[4] No specific definition of insider trading exists in the broad antifraud provision in Section 10(b) of the Exchange Act[5] or its companion rule, Securities and Exchange Commission (SEC) rule 10b-5.[6] Congressional efforts to enact a definition have not been successful to date. In 1987 the SEC

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regulates trading by corporate insiders, a class which includes only officers, directors, and beneficial owners of 10% of any class of equity securities. 15 U.S.C. § 78p(a) (1988). This section permits a corporation or its shareholders to sue to recover short-swing profits made by an insider in transactions in the company's securities when the insider purchases and sells, or sells and purchases, the company's stock during a six month period. 15 U.S.C. § 78p(b) (1988).

To trigger liability under § 16, both a purchase *and* a sale, or vice-versa, must occur within a six month period. Section 16 does *not* prohibit unmatched purchases or sales by insiders during the statutory period even if the trades are based on material nonpublic information. Therefore, § 16 does not prevent some fraudulent insider trading by even the narrow class of persons subject to its prohibitions. *See* Samuelson, *The Prevention of Insider Trading: A Proposal for Revising Section 16 of the Securities Exchange Act of 1934*, 25 HARV. J. ON LEGIS. 511, 518 (1988).

3. 15 U.S.C. § 77a (1988).

4. *Id.* § 78a (1986).

5. *Id.* § 78j(b) (1988). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b) (1988).

6. 17 C.F.R. 240.10b-5 (1989). The rule provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (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
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> (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.

proposed legislation to codify a definition of illegal insider trading that would make unlawful the purchase or sale of a security while in possession of "material, nonpublic information" when the use of the information is "wrongful."[7] The SEC's support for a legislative definition of insider trading reversed its long-standing position in opposition to congressional efforts to enact such a definition.[8]

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7. Insider Trading Proscriptions Act of 1987, *reprinted in* 19 Sec. Reg. & L. Rep. (BNA) 1817 (1987) [hereinafter *SEC Legislative Proposal*]. The SEC's proposed legislation deems use of the information wrongful when:

> [S]uch information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electric or other means) or (B) conversion, misappropriation, or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.

Id. Corporate entities could avoid liability under the section if they prove that the information was not used in trading or did not influence the investment decision, and if appropriate "Chinese wall" procedures are in place. *See id.*

The SEC's legislative proposal was a compromise arising out of meetings between the SEC and an Ad Hoc Legislative Committee formed by the private securities bar. Letter from David S. Ruder, Chairman, Securities and Exchange Commission, to Senators Donald W. Riegle and Alfonse M. D'Amato (Nov. 18, 1987), *reprinted in* 19 Sec. Reg. & L. Rep. (BNA) 1819 (1987). The SEC's proposal included a provision granting a cause of action to private parties who trade contemporaneously with persons whose trading violates rule 10b-5. This provision was enacted as part of the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

Senators Riegle and D'Amato requested that the Ad Hoc Legislative Committee draft a bill defining insider trading, which was introduced on June 17, 1987, as S. 1380. 100th Cong., 1st Sess., 133 CONG. REC. S8297 (daily ed. June 17, 1987); *see Definition of Insider Trading, Hearings Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 35-36 (1987) (joint written statement of Harvey L. Pitt and John F. Olson). The Ad Hoc Legislative Committee proposal prohibits the use of information obtained "wrongfully" and the "wrongful use" of the information in a purchase or sale. Information is obtained "wrongfully" when it is obtained by "theft, conversion, misappropriation or a breach of any fiduciary, contractual employment, personal or other relationship of trust and confidence." S. 1380, § 2(b)(1), 100th Cong., 1st Sess., 133 CONG. REC. S8297 (daily ed. June 17, 1987). The information subject to the prohibition includes information relating to the "market" for a security. *Id.* § 2(b)(2).

8. Senator D'Amato pushed strongly for legislation defining insider trading during the Senate's consideration of the Insider Trading Sanctions Act of 1984. *See* 130 CONG. REC. S8912-13 (daily ed. June 29, 1984) (statement of Sen. D'Amato). Senator D'Amato's proposal would have prohibited trading while in possession of material nonpublic information when use of the information violated "fiduciary or other contractual obligations." *See The Insider Trading Sanctions Act of 1983, Hearing on H.R. 559 Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs*, 98th Cong., 2d Sess. 8-10 (1984) (draft legislation of Sen. D'Amato).

Although the legislation passed by Congress in 1984 uses the term "insider trading" in its title and the legislative history is replete with references to it, the act only refers to

The effort to codify a definition springs in part from the haphazard development of the law of insider trading. The provisions that govern insider trading, Section 10(b) and rule 10b-5, are catchall antifraud provisions that were drafted to ensure flexibility rather than to serve as strict guides for conduct.[9] Seeking to limit the breadth of these antifraud provisions in the insider trading context, the Supreme Court required in *Chiarella v. United States*[10] that the trading defendant owe a fiduciary duty to the corporation and its shareholders as a prerequisite for liability.[11] In *Dirks v. SEC*,[12] the Court reaffirmed the *Chiarella* holding on the fiduciary duty standard, stating that there is no general duty to disclose material information before trading unless such a duty arises "from the existence of a fiduciary relationship."[13]

The government has been able to effectively bypass the holdings of *Chiarella* and *Dirks* by relying on the misappropriation theory in enforcement actions against persons who are not insiders of the issuer. This theory proscribes the wrongful conversion of material nonpublic information in connection with a securities transaction. Liability may be imposed regardless of whether one has a fiduciary duty to the corporation or its shareholders.[14] Until 1988, however,

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transactions by persons "in possession of material nonpublic information," and relies on the courts to determine what types of trading violate rule 10b-5. *See* 130 CONG. REC. H7758 (daily ed. July 25, 1984) (language of the legislation is not designed to restrict the flexibility of the courts to determine violations). The legislative deference to the judiciary's rules for what conduct constitutes insider trading was repeated in the creation of a private cause of action enabling contemporaneous traders to sue for insider trading. *See infra* text accompanying notes 146-160.

9. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976).

10. 445 U.S. 222 (1980). *See infra* text accompanying notes 55-77 (discussing *Chiarella*).

11. The Supreme Court described the fiduciary duty necessary for the imposition of liability for insider trading as "a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Id.* at 230.

12. 463 U.S. 646 (1983). *See infra* text accompanying notes 78-87 (discussing *Dirks*).

13. *Id.* at 654.

14. The Supreme Court refused to consider the misappropriation theory in *Chiarella*, 445 U.S. at 236. In Carpenter v. United States, 484 U.S. 19 (1987), the Court split 4-4 in upholding the Second Circuit's application of the theory to trading by a reporter who used information about companies discussed in a news column prior to its publication in the *Wall Street Journal*. *See infra* text accompanying notes 115-125 (discussing *Carpenter*).

Recent SEC insider trading cases continue to rely, in part, on the misappropriation theory. *See, e.g.*, SEC v. Saul, No. 90 Civ. 2633 (N.D. Ill. filed May 8, 1990) (Complaint ¶ 17); SEC v. Finacor Anstalt, No. 89 Civ. 7667 (S.D.N.Y. filed Sept. 16, 1990) (First Amended Complaint ¶ 12); SEC v. Wang and Lee, No. 88 Civ. 4461 (S.D.N.Y. filed June 27, 1988) (Complaint ¶ 12); SEC v. Drexel Burnham Lambert, Inc., No. 88 Civ. 6209 (S.D.N.Y. filed Sept. 7, 1988) (Complaint ¶¶ 179, 521, 654, 672). The government's use of the misappropriation theory has, however, been criticized by commentators who argue that the theory does not comport with *Chiarella*'s fiduciary duty principle. Phillips & Zutz, a decision by the Second Circuit prevented private parties from relying on the misappropriation theory as a means of recovery for insider trading,[15] and other courts used *Chiarella* to restrict standing for private rule 10b-5 actions.[16] Thus, although *Chiarella* and *Dirks* involved government criminal and civil enforcement actions, these cases limit the ability of private parties to sue for alleged violations of rule 10b-5.

The development of new financial instruments and forms of corporate transactions in recent years places the fiduciary duty principle at odds with the economic reality of the securities markets and the goals of the federal securities laws.[17] Persons who may be injured by illegal insider trading generally fall into three categories: (1) purchasers and sellers of equity securities; (2) purchasers and sellers of derivative securities, such as options, and debt securities;

The Insider Trading Doctrine: A Need for Legislative Repair, 13 HOFSTRA L. REV. 65, 91 (1984) (misappropriation theory is a "misconceived effort to broaden the narrow focus of the insider trading doctrine"); Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 984 (misappropriation theory conflicts with *Chiarella* by disassociating fraudulent act from investor's decision to purchase or sell); Warren, *Who's Suing Who? A Commentary on Investment Bankers and the Misappropriation Theory*, 46 MD. L. REV. 1222, 1248 (1987) (misappropriation theory works a serious distortion of rule 10b-5); Note, *The Misappropriation Theory: Rule 10b-5 Insider Liability for Nonfiduciary Breach*, 15 FORDHAM URB. L.J. 1049, 1071-72 (1987) (misappropriation theory not related to purposes of the Exchange Act); Note, *The Supreme Court's Missed Opportunity: Carpenter v. United States*, 11 GEO. MASON U.L. REV. 225, 234 (1988) (misappropriation theory applied in *Carpenter* reaches acts outside the scope of rule 10b-5); Comment, *The Misappropriation Theory: The Wrong Answer to the Chiarella Question*, 32 N.Y.L. SCH. L. REV. 701, 720 (1987) (misappropriation theory inconsistent with the securities laws); Note, *Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far?*, 61 ST. JOHN'S L. REV. 78, 103-04 (1986) (misappropriation theory conflicts with Supreme Court precedents interpreting rule 10b-5); *See* Note, *United States v. Carpenter: An Inadequate Solution to the Problem of Insider Trading*, 34 WAYNE L. REV. 1461, 1473 (1988) (misappropriation theory creates confusion in application to rule 10b-5 that must be addressed by Supreme Court). *But see* Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 119-21 (1984) (misappropriation theory properly reaches conduct that defrauds investors); Note, *To Catch a Thief: The Misappropriation Theory and Securities Fraud*, 70 MARQ. L. REV. 692 (1987) (misappropriation theory is proper standard for liability under rule 10b-5).

15. Moss v. Morgan Stanley, Inc., 719 F.2d 5, 16 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984) (*Chiarella* and *Dirks* bar private rule 10b-5 actions based on the misappropriation theory). *See also infra* text accompanying notes 133-35 (discussing *Moss*).

16. *See, e.g.*, Laventhall v. General Dynamics Corp., 704 F.2d 407, 411-12 (8th Cir.) (no relationship of trust and confidence between parties requires dismissal of claim by options trader for insider trading), *cert. denied*, 464 U.S. 846 (1983).

17. *See* Seligman, *The Reformulation of Federal Securities Laws Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1108-09 (1985) (federal securities laws were designed to produce parity of information to protect investors).

and (3) corporations involved in transactions that were the subject of the material nonpublic information used in connection with inside trading in that corporation's securities. Only members of the first category—purchasers and sellers of equity securities—can satisfy *Chiarella*'s requirement for a private rule 10b-5 action for insider trading, because they are the only ones owed the fiduciary duty of disclosure.[18]

Members of the other two categories, whose potential injury from insider trading may be at least as great as those in the first category, have fought to persuade courts to expand the reading of *Chiarella* and *Dirks* to find that they have standing to bring a securities fraud claim.[19] These efforts have been largely unsuccessful because the fiduciary duty requirement is formalistic and looks solely to the legal relationship between the parties, rather than the effect insider trading has on investors. Moreover, courts differ as to which purchasers or sellers are the proper plaintiffs.[20] Thus, as interpreted by the courts, rule 10b-5 has not been flexible enough to deal with developing transactions and securities.

Congress first addressed the question of private party standing in the Insider Trading Sanctions Act of 1984 (ITSA), which granted options traders standing to sue persons trading in options while in possession of material nonpublic information.[21] The options trader provision, added to the Exchange Act as Section 20(d), eliminated *Chiarella's* fiduciary duty requirement for options investors because there is no relationship of "trust and confidence" between persons trading in options.[22] Congress adopted the options trader standing

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18. *See infra* text accompanying notes 55-77 (discussing restrictive effect of *Chiarella* on rule 10b-5).

19. *See, e.g.*, *Laventhall*, 704 F.2d at 411 (options trader argued that *Chiarella* was distinguishable when defendant was insider of company); FMC Corp. v. Boesky, 852 F.2d 981, 991 (7th Cir. 1988) (corporation whose information was misappropriated argued that defendants, who were neither employees nor advisors of corporation, breached fiduciary duty to corporation in violation of rule 10b-5).

20. *Compare* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (defendant liable to all persons who traded in open market in security during same period), *with* Fridrich v. Bradford, 542 F.2d 307, 318-19 (6th Cir. 1976) (plaintiffs in open market transactions may not sue alleged inside trader because they cannot prove defendant caused injury), *cert. denied*, 429 U.S. 1053 (1977). In an often cited concurrence in *Fridrich*, Judge Celebrezze proposed an alternative standard, permitting plaintiffs that traded "contemporaneously" with the defendant to sue under rule 10b-5. *Id.* at 326. Both the majority and concurrence in *Fridrich* expressed an aversion to permitting a broad class of plaintiffs to sue because that would open a defendant to "Draconian" liability for the losses of all traders in the market. *Id.* at 321, 323.

21. 15 U.S.C. § 78t (1988).

22. *See* Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1290-91 (1984) (private cause of action for options traders contrary to *Chiarella-Dirks* fiduciary duty rule).

provision almost as an afterthought,[23] but that provision effectively undermined any theoretical consistency *Chiarella*'s fiduciary duty principle may have had in limiting private party standing to only those who are owed a duty of disclosure by the defendant.

On November 19, 1988, President Reagan signed into law the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA),[24] which provides a private right of action to contemporaneous traders against any person trading "while in possession of material, nonpublic information."[25] Damages are limited to the insider's profit gained or loss avoided on the transaction, and are offset by any SEC civil enforcement action penalties.[26] Congress gave only perfunctory attention to private rights of action, and ITSFEA's legislative history concerning insider trading is limited, consisting primarily of anecdotal recitations of the breadth of insider trading on Wall Street.[27] In order to facilitate passage of the bill, the House declined to define insider trading and eliminated a provision extending the private right of action to corporations

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23. The options trader standing provision was added by the Senate to a bill passed earlier by the House, 130 CONG. REC. S8911-14 (daily ed. June 29, 1984), and the House accepted the Senate's amendment. There is neither a Senate nor a Conference Committee report discussing § 20(d), and floor statements concerning the provision are sparse, with no mention of how the provision can be reconciled with *Chiarella*. *See id.* at 8912-14 (remarks of Sen. D'Amato); 130 CONG. REC. H7758-59 (daily ed. July 25, 1984) (analysis of Senate amendments repeats statements of Sen. D'Amato); *see also* Wang, *A Cause of Action for Option Traders Against Insider Option Traders*, 101 HARV. L. REV. 1056, 1058 & n.11 (1988) (discussing legislative history of § 20(d)).

24. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified at 15 U.S.C. § 78t-1 (1988)).

25. 15 U.S.C. § 78t-1(a) (1988).

26. 15 U.S.C. § 78t-1(b)(1) to (2). The limitation on damages also extends to controlling persons, who cannot be liable on the basis of *respondeat superior* for the violations of employees. *Id.* Controlling person liability to contemporaneous traders for insider trading is governed by § 20(a) of the Securities Exchange Act of 1934, which provides:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1988). The House softened the blow of only providing contemporaneous traders a cause of action by encouraging the federal courts to continue the trend of expanding the classes of plaintiffs that can recover in rule 10b-5 actions. ITSFEA provides that "[n]othing in this section shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of this chapter." 15 U.S.C. § 78t-1(d) (1988).

27. *See House Comm. on Energy and Commerce, Insider Trading and Securities Fraud Enforcement Act of 1988*, H. REP. No. 910, 100th Cong., 2d Sess. 11-14 (1988) (reviewing "Post-ITSA Wall Street Scandals") [hereinafter *House ITSFEA Report*].

that did not trade contemporaneously but were otherwise damaged by the violation.[28]

Congressional expansion of the private right of action for options traders and contemporaneous traders allows many private parties to be in the same position as the government in bringing actions against inside traders. Recent expansion of the right to sue, however, has not reached all securities holders that may be affected by insider trading. *Chiarella* therefore remains an important limitation on the scope of rule 10b-5 actions.

By eliminating the fiduciary duty requirement as an element of a private cause of action, and explicitly granting standing to "contemporaneous" traders and other persons injured by insider trading, Congress has embraced the assumption that more private suits are desirable. Allowing more plaintiffs to sue may provide greater coherence to the law of insider trading, but whether that expansion will aid enforcement of the antifraud provisions or merely encourage lawsuits that piggyback on government enforcement efforts is an open question.[29] Moreover, private actions will raise procedural issues[30] that may divert judicial attention from more important questions of liability. By adopting a piecemeal approach, Congress left the issue of private party standing unresolved. This gradual expansion of private rights of action for insider trading does not settle exactly which parties remain subject to *Chiarella*'s fiduciary duty principle.

This Article examines the anomalous state of the law caused by Congress's piecemeal approach to determining the scope of private causes of action for insider trading and the resulting confusion about which private parties may bring claims for insider trading. The Article begins by discussing the basic requirements for private party standing under rule 10b-5, the development of the fiduciary duty principle, and the misappropriation theory applied by the government in response to the limitations imposed by *Chiarella*. In Part III, the Article analyzes which parties can bring claims,

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28. *See* Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145, 151, 168 (1989) (Senate could not reach consensus on definition of insider trading, and Rep. Dingell, chair of House committee considering bill, strongly opposed any such definition; to preserve support for bill, House committee deleted provision granting broad right of action to noncontemporaneous traders).

29. *See, e.g.*, Adler & Cohen, *Drexel Faces a Stockholder Suit Claiming Injury from Wrongdoing Alleged by SEC*, Wall St. J., Sept. 9, 1988, at 8, col. 1 (private suit against Drexel Burnham Lambert piggybacking on SEC insider trading and market manipulation complaint filed the previous day).

30. For instance, defining the class of "contemporaneous traders," which is necessary in some private actions, will be time consuming and difficult.

and which securities are subject to private actions for injury caused by insider trading and other rule 10b-5 violations. The Article then discusses how the courts have analyzed private rule 10b-5 actions for different classes of securities and reviews the effect of Congressional enactments on private plaintiffs' rights to bring claims. Finally, the Article identifies the private parties who, although adversely affected by an alleged violation, cannot bring an action under rule 10b-5. The Article concludes with a discussion of the anomaly caused by Congressional action in this area, which has left crucial gaps in the private enforcement of laws prohibiting insider trading.

II. Standing Limitations on Private Rule 10b-5 Actions

For more than forty years, courts have recognized a private cause of action for violations of rule 10b-5.[31] The Supreme Court has described this type of claim as a judicial oak sprouting from a tiny acorn.[32] The elements of a private rule 10b-5 violation are well established, and are drawn from the common law tort of deceit:[33] (1) a misstatement or omission; (2) materiality; (3) scienter; (4) reliance; and (5) proximate cause.[34] Although the Supreme Court gradually relaxed the materiality and reliance requirements, it raised the standing requirements for a rule 10b-5 action, thereby restricting the number of potential plaintiffs.[35]

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31. The private cause of action for violation of rule 10b-5 was first recognized in Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

32. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) ("When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn."). *Cf.* Herman & MacLean v. Huddleston, 459 U.S. 375, 380 (1983) ("The existence of this implied remedy is simply beyond peradventure.").

33. L. Loss, Fundamentals of Securities Regulation 809 (1983). Professor Loss notes that courts have been loath to define "fraud" with any specificity, both in the securities laws and the common law tort of deceit. *Id.* at 813.

34. Ross v. Bank South N.A., 885 F.2d 723, 728 (11th Cir. 1989), *cert. denied*, 110 S.Ct. 1924 (1990); Peil v. Speiser, 806 F.2d 1154, 1160 (3d Cir. 1986) (court also added resulting damage as a sixth element).

35. One explanation for the liberalization of the proof requirements is that many private securities fraud cases are class actions, typically involving relatively small individual claims for losses. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 227-28 (1988) (class action by former shareholders alleging material misstatements concerning ongoing merger negotiations); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 466-67 (1977) (suit by minority shareholders alleging breach of fiduciary duty in short-form merger); *Blue Chip Stamps*, 421 U.S. at 723 (class action by offerees alleging material misstatements concerning overly pessimistic valuation of company). In order to facilitate class treatment of the claims, courts eliminate or reshape those elements that are more individualistic, such as reliance, in order to satisfy the Federal Rule of Civil Procedure 23(b)(3) requirement that common questions of fact or law predominate.

In *Affiliated Ute Citizens v. United States*,[36] the Supreme Court held that when defendants fail to disclose material facts plaintiffs need not prove reliance. Parties allegedly injured by such omissions cannot prove that they would have traded differently had a proper disclosure been made.[37] Although *Affiliated Ute* involved a face-to-face transaction, courts have expanded its application to include open market transactions, when the parties never deal directly with each other.[38] The reliance element of a rule 10b-5 violation, therefore, merges into the materiality inquiry in claims alleging a failure to disclose information.

In *Basic v. Levinson*,[39] the Supreme Court held that, for all rule 10b-5 actions, "materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."[40] Although the materiality element is fact-specific, omitted information is almost always material in insider trading cases when the insider's purchases or sales are made in anticipation of the dissemination of information that will raise or lower the stock's price.

The Supreme Court eroded the reliance element even more by its narrow endorsement of the "fraud-on-the-market" theory in *Basic*. Under this theory, there is a rebuttable presumption that plaintiffs relied on material misstatements when the information was disseminated into an impersonal, well-developed securities market.[41] The relaxation of the reliance requirement in open market cases also eases the burden of proving that the material misstate-

36. 406 U.S. 128 (1972).

37. *Id.* at 153-54. *Affiliated Ute* involved a claim by members of a Native American tribe against a bank and two of its employees who allegedly misled tribe members concerning sales of stock in a tribal corporation by failing to inform them of certain important information about the market for their stock. *Id.* at 152.

38. *See* Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C.L. REV. 435, 444-45 ("Based on *Affiliated Ute*, courts accord plaintiff a presumption of reliance in nondisclosure cases and, in so doing, shift the burden to defendant to prove plaintiff's nonreliance.").

39. 485 U.S. 224 (1988).

40. *Id.* at 240. The Court noted that the materiality standard applies to both insider trading cases, which involve a failure to disclose, and affirmative misrepresentation cases. *Id.* n.18.

41. *Id.* at 241-42 (quoting Peil v. Speiser, 806 F.2d 1154, 1160-61 (3d Cir. 1986)). The Court permitted plaintiffs to use the rebuttable presumption because direct proof of reliance is difficult when trading occurs on a large securities market, and because adoption of the presumption facilitates class treatment of the individual claims. *Id.* at 242-44. *Basic* notes that "our understanding of Rule 10b-5's reliance requirement must encompass these differences." *Id.* at 244. The dissent objected to the adoption of the "fraud-on-the-market" theory as a novel construction of 10b-5, "based on contemporary microeconomic theory," which may be incorrect. *Id.* at 253 (White, J., dissenting).

ment or omission proximately caused the plaintiff's loss. The "fraud-on-the-market" theory assumes that material information will be assimilated into the security's price, thereby causing the damage suffered by the plaintiffs.[42]

A. Limiting the Scope of Rule 10b-5 before Chiarella.

The Supreme Court's approach to the materiality and reliance elements is based on the efficient market theory, which hypothesizes that, within a very short period of time, the securities markets digest information and adjust stock prices accordingly.[43] Information is the currency of the securities markets. Even slight advantages in the type of information available or the timing of its dissemination can permit traders to reap enormous profits. Not all such advantages involve fraud, however. Determining the legal basis that requires a person to disclose nonpublic information before trading or abstain from trading is the focus of the Supreme Court's effort to limit rule 10b-5 actions for insider trading.

The Supreme Court reads the materiality and reliance requirements for a rule 10b-5 violation expansively, making it easier for plaintiffs to recover. The Court's distrust of judicially created private actions,[44] however, has caused it to narrow the types of conduct which may constitute a rule 10b-5 violation, thereby limiting the class of potential plaintiffs. In *Blue Chip Stamps v. Manor Drug Stores*,[45] the Supreme Court restricted standing in class actions to actual purchasers or sellers of the security at issue.

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42. *Id.* at 247. "An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." *Id.*

43. Kuehner & Renwick, *Comments on the Efficient Market-Random Walk Hypothesis*, in THE FINANCIAL ANALYST'S HANDBOOK 1221 (2d ed. 1988). The theory has three variations: (1) *weak*, which holds that a security's present price reflects all past information, but the information does not predict future movements of the price; (2) *semistrong*, the most widely accepted theory, which holds that current market prices instantaneously reflect all public information available concerning a company; and (3) *strong*, which holds that current market prices reflect all possible information about a company, both public and nonpublic. *Id.* at 1226-28. In *Basic*, the Supreme Court accepted the semistrong form of the efficient market theory, stating that "because most publicly available information is reflected in market price, an investor's reliance on public material misrepresentations, therefore, may be presumed." *Basic*, 485 U.S. at 247.

44. *See* Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11, 24 (1979) (refusing to imply a private cause of action for damages under § 206 of the Investment Advisers Act of 1940); Touche Ross & Co. v. Redington, 442 U.S. 560, 571 (1979) (refusing to imply a private cause of action under § 17(a) of the Exchange Act); Piper v. Chris-Craft Indus., 430 U.S. 1, 35 (1977) (refusing to imply a private cause of action for unsuccessful tender offerors under § 14(e) of the Williams Act).

45. 421 U.S. 723 (1975).

The plaintiffs in *Blue Chip* were offerees of stock in a reorganized corporation who alleged material misstatements related to overly pessimistic projections in the prospectus.[46] The plaintiffs claimed that, because of these pessimistic projections, they failed to purchase the securities offered at a bargain price, and sought to recover the value of the "lost opportunity."[47] The Supreme Court rejected the plaintiffs' claim and adopted the Second Circuit's *Birnbaum* rule,[48] which limits the plaintiff class to actual purchasers and sellers. Although the Court acknowledged the arbitrariness of excluding nontransacting plaintiffs who were damaged by the fraudulent statements,[49] it found that limiting the plaintiff class to parties that actually participated in transactions comported with its view that a judicially created cause of action requires some practical limitations on its scope.[50] Thus, the Supreme Court's desire to limit standing to those who presented easily verifiable claims won out over a more theoretically plausible standing test.

The Supreme Court put an additional gloss on the requirements for a private rule 10b-5 claim in *Santa Fe Industries, Inc. v. Green*.[51] Minority shareholders claimed that the terms of a merger adopted by the majority shareholder violated federal securities laws because the terms violated state fiduciary duty law. By emphasizing the need to prove a separate deceptive act as a predicate to a federal securities law claim, the *Santa Fe* Court rejected a broad reading of rule 10b-5 that would have permitted plaintiffs to bring claims in federal court for violations of state corporate law.[52] Although the minority shareholders of Santa Fe Industries asserted that the majority shareholder breached the fiduciary duty of fair-

46. *Id.* at 726.

47. *Id.* at 726-27.

48. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

49. "The *Birnbaum* rule undoubtedly excludes plaintiffs who have in fact been damaged by the violations of Rule 10b-5, and to that extent it is undesirable." *Blue Chip Stamps*, 421 U.S. at 743. The Court noted three classes of potential plaintiffs excluded by the actual purchaser or seller rule: (1) potential purchasers who decide not to acquire shares because of a pessimistic representation or omission of favorable information; (2) actual shareholders who do not sell because of an optimistic representation or a failure to disclose unfavorable information; and (3) "shareholders, creditors and perhaps others related to an issuer" whose investments lose value because of insider trading. *Id.* at 737-38. Plaintiffs in the second category, however, are not affected by the *Birnbaum* rule to the extent that they can bring derivative suits on behalf of the corporation to recover for any violation.

50. *Id.* at 748-49.

51. 430 U.S. 462, 468 n.6 (1977).

52. *Id.* at 476. The Court noted that if it permitted the claim under the federal securities laws, "[t]he result would be to bring within [rule 10b-5] a wide variety of corporate conduct traditionally left to state regulation." *Id.* at 478.

ness, they did not allege that material misstatements or omissions were made in connection with the merger. The Supreme Court reviewed the language of rule 10b-5 and determined that it only prohibits conduct involving "manipulation or deception."[53] Therefore, absent some element of deception, misrepresentation, or nondisclosure, breaches of state law fiduciary duties are not violations of federal law.[54]

B. *The Limits of* Chiarella's *Fiduciary Duty Principle*

Although *Blue Chip* and *Santa Fe* limited private plaintiffs' right to sue under rule 10b-5, it was not until *Chiarella v. United States*[55] that the Supreme Court placed serious roadblocks in the path of private parties seeking recovery for insider trading claims. In *Chiarella*, the Supreme Court considered for the first time the scope of rule 10b-5 in transactions by persons with knowledge of material nonpublic information. The case was a criminal prosecution, but the Court's broad review of the policies underlying Section 10(b) and rule 10b-5 makes it applicable as well to private insider trading actions. Chiarella worked in the composing room of a financial printer and had access to disclosure documents related to takeovers prior to the public release of the information.[56] He deciphered the identities of five target companies and purchased shares before the announcements, realizing a profit of approximately thirty thousand dollars.[57] Chiarella was convicted on seventeen counts of violating Section 10(b) and rule 10b-5.[58]

At trial, there was no dispute concerning the materiality of the information or the fact Chiarella failed to disclose the information prior to trading.[59] The government's primary argument was that the defendant's "secret conversion of confidential information" and subsequent transactions based on that information worked the requisite fraud to uphold the conviction.[60] At trial, the district court charged the jury that Chiarella employed a scheme to defraud if he "did not disclose . . . material non-public information in

53. *Id.* at 473. ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

54. *Id.* at 476.

55. 445 U.S. 222 (1980).

56. *Id.* at 224.

57. *Id.*

58. In a settlement with the SEC, Chiarella consented to a permanent injunction and disgorgement of the profits from his trading. *Id.*

59. *Id.* at 244-45 (Burger, C.J., dissenting).

60. *Id.*

connection with the purchases of the stock."[61] The United States Supreme Court held the instruction was deficient because it did not include the "nature or elements of a duty owed by petitioner to anyone other than the sellers."[62]

The government's theory of liability was that all persons *in possession* of material nonpublic information are under a duty to either disclose the information or refrain from trading,[63] a position that can be traced to the SEC's decision in *Cady, Roberts & Co.*[64] In *Cady, Roberts*, an administrative proceeding, the Commission found that a registered representative of a broker-dealer violated federal law by failing to reveal information that he had received from a director prior to trading.[65] The SEC concluded that persons with material nonpublic information were under an affirmative duty to disclose the information or abstain from trading when two factors were present:

> [F]irst, 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.[66]

Although the broker in *Cady, Roberts* was not an insider of the company whose information he received, the SEC expanded the scope of the antifraud prohibition to cover those who come into possession of material nonpublic information from the corporation.[67]

The Second Circuit followed the *Cady, Roberts* approach in *SEC v. Texas Gulf Sulphur*.[68] The court applied the disclose-or-abstain rule to corporate insiders and their tippees who traded both stock and options while they had knowledge of test results showing rich mineral and ore deposits over which the corporation was seeking the right to mine.[69] The circuit court held:

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61. *Id.* at 236.

62. *Id.*

63. *Id.* at 231.

64. 40 S.E.C. 907 (1961).

65. *Id.* at 915 (citations omitted).

66. *Id.* at 912. *Cady, Roberts* involved sales made immediately before the announcement of a reduction in a dividend that caused the issuer's stock price to drop approximately $6 per share. *Id.* at 909-10. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 8 (1982) (Commission's decision does not discuss how the failure to disclose constitutes fraud, beyond describing the act as inherently unfair).

67. "The facts here impose on [the broker] the responsibilities of those commonly referred to as 'insiders.' " *Cady, Roberts*, 40 S.E.C. at 912.

68. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

69. *Id.* at 843-47.

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . , or he chooses not to do so must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[70]

The Second Circuit's decision to extend rule 10b-5 to cover all trading on material nonpublic information was based on the policy decision that all investors in open market transactions should have equal access to information.[71] *Texas Gulf Sulphur* thus interpreted rule 10b-5 as imposing liability based solely on possession of the information prior to trading, without reference to the status of the defendant or the relationship to the parties on the other side of the transactions.

In *Chiarella*, the United States Supreme Court acknowledged the holding of *Cady, Roberts*—that a duty to disclose may apply when a person with material information trades—but the Court rejected the proposition that a duty of disclosure arises "from the mere possession of nonpublic market information."[72] Relying on *Santa Fe*'s holding that rule 10b-5 only applies to fraud, that is, manipulation or deception, the Supreme Court narrowed the applicability of rule 10b-5 to insider trading by holding that such trading does not violate the antifraud provisions unless the defendant is subject to an affirmative duty to disclose information before trading.[73] According to the Court, the breach of a fiduciary duty supplies the necessary fraud under rule 10b-5, and the source of the disclosure duty was the "relationship of trust and confidence between parties to a transaction."[74] Chiarella did not owe a duty to disclose or refrain from trading because he was "a complete stranger who dealt with the sellers only through impersonal market transactions."[75] Thus, Chiarella could not be held liable for a violation of rule 10b-5, and the Court dismissed the conviction.[76]

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70. *Id.* at 848.

71. *Id.* at 849.

72. Chiarella v. United States, 445 U.S. 222, 235 (1980).

73. *Id.* at 231.

74. "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." *Id.* at 235.

75. *Id.* at 233.

76. *Chiarella*'s reliance on the fiduciary duty principle to limit the scope of rule 10b-5 for insider trading is questionable in view of the common law's inconsistent treatment of corporate fiduciary duties. The common law was split over whether corporate insiders, *i.e.*, directors and officers, owe a duty to shareholders when they trade in securities in private transactions. Under the "majority" rule, the insider's duty ran only to the corporation, and therefore trading while in possession of material nonpublic information did not create any liability to shareholders. *See* Aldave, *supra* note 15, at 104 (same); Seligman,

Chiarella did not address whether the only persons owing a duty of disclosure are the traditional corporate insiders, or whether trading on an impersonal market can violate the duty of disclosure. Instead, the opinion focused solely on Chiarella's failure to meet the fiduciary duty standard. Until the Supreme Court specifically determined who is charged with the duty of disclosure, *Chiarella* could have been read to limit rule 10b-5 exclusively to traditional insiders. Such a narrow interpretation would have left large categories of persons with access to material nonpublic information, such as investment bankers or outside legal counsel, free to trade without violating the antifraud provisions.[77]

In *Dirks v. SEC*,[78] decided three years after *Chiarella*, the Supreme Court addressed the question of who is charged with the disclosure duty. In *Dirks*, a case involving "tipping" by an investment analyst,[79] the Court affirmed its *Chiarella* analysis by

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supra note 17, at 1091-98 (reviewing common law fiduciary duties of insiders to shareholders). It is an open question, however, whether the "majority" rule was in fact anything more than the most traditional, restrictive view of the fiduciary duties owed by insiders to shareholders. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 725 (1986) (so-called majority view gradually giving way); Langevoort, *supra* note 66, at 5 (trend of cases was toward finding a fiduciary duty owed by insiders to shareholders).

In Strong v. Repide, 213 U.S. 419 (1909), the Supreme Court softened the "majority" rule, imposing a duty on shareholders when "special circumstances" were present that required a controlling shareholder to reveal certain facts prior to trading. *Id.* at 431-33 (director and 75% owner of the Philippines Sugar Estates Development Company purchased the plaintiff's stock while concealing his identity through the use of an agent and a third-party check). Conversely, the "minority" rule imposed on insiders a broad duty to disclose material nonpublic information. *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 724 n.2 (1986); Langevoort, *supra* note 66, at 5 n.12.

In those jurisdictions that accepted either the minority or special circumstances rule, the common law fiduciary duty of disclosure had two important limitations. First, the obligation only bound officers and directors of the corporation, the traditional insiders. Second, the duty appears to have applied only in face-to-face transactions and not to open market transactions. *See* Seligman, *supra* note 17, at 1101 (discussing limitations of common law prohibitions of insider trading). Common law actions for securities fraud based on nondisclosure are of limited application to rule 10b-5 insider trading claims involving large-scale transactions on national exchanges. Moreover, the common law has not defined with any precision the duty owed by insiders. Nevertheless, *Chiarella* adopted the fiduciary duty principle as the means of limiting the scope of rule 10b-5.

77. *See* Langevoort, *supra* note 66, at 17 (if read literally as establishing outer limits of liability, *Chiarella* would lead to arbitrary and inconsistent results).

78. 463 U.S. 646 (1983).

79. Dirks received information from a former officer of Equity Funding of America that the company had engaged in fraudulent accounting practices that overstated its earnings and assets. After investigating the allegations with the company, Dirks advised his clients to sell their holdings. The SEC censured Dirks for violating the antifraud provisions by not disclosing the information prior to tipping the clients that traded. In re Dirks, 47 S.E.C. 434, 449 (1981).

rejecting the possession theory of liability for insider trading under rule 10b-5,[80] stating that the disclosure duty arises only when there is a pre-existing fiduciary relationship.[81] *Dirks*, however, expanded the category of those who have a fiduciary duty to include "temporary" insiders. The opinion addressed the issue of who may be subject to rule 10b-5's insider trading prohibition in a footnote:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the enterprise and are given access to information solely for corporate purposes.[82]

This approach was not based on the traditional principles of corporation law, but was a pragmatic effort to provide flexibility to *Chiarella*'s limitation of those subject to the insider trading prohibition. Moreover, the duty of these "temporary" insiders may be passed on to tippees when the tipper breaches a duty by disclosing the information for some direct or indirect benefit.[83]

The *Chiarella* and *Dirks* decisions had a profound impact on the law of insider trading.[84] For private parties, these decisions

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80. *Dirks*, 463 U.S. at 656-58.

81. *Id.* at 657-58. The Supreme Court rejected the SEC's renewed attempt to impose an equal access rule for liability under rule 10b-5, stating that "mere possession of nonpublic information does not give rise to a duty to disclose or abstain; only a specific relationship does that." *Id.* at 656 n.15.

82. *Id.* at 655 n.14.

83. "Thus, the tippee's duty to disclose or abstain is derivative from that of the insider's duty." *Id.* at 659 (citing Chiarella v. United States, 445 U.S. 222, 246 n.1 (1980) (Blackmun, J., dissenting)). In order for the derivative fiduciary duty to apply, the tip must constitute a breach of the insider's own duty. "[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of a duty to stockholders. And absent a breach by the insider, there is no derivative breach." *Id.* at 662. For example, if attorneys working on a hostile tender offer pass on material nonpublic information about the transaction to their personal accountants in order to gain some benefit, even a nonmonetary benefit, and if the accountants trade, only then will the accountants be subject to the *Dirks* disclosure duty.

84. One response to *Chiarella* was the SEC's adoption of rule 14e-3, which prohibits transactions in securities that are the subject of a tender offer on the basis of material nonpublic information when the information has been acquired from the offeror, the issuer, or any officer, director, partner, or employee of the offeror or issuer. 17 C.F.R. § 240.14e-3 (1989). Rule 14e-3 would reach trading similar to that at issue in *Chiarella*, but not in *Dirks*, which involved nondisclosure of material corporate financial information. It is interesting to note that rule 14e-3 imposes a duty to abstain from trading based solely on possession of the information relating to a tender offer, a position twice rejected by the Supreme Court as applicable to rule 10b-5. *See* Phillips & Zutz, *supra* note 14, at 67-68.

made the possibility of recovery under rule 10b-5 problematic. *Chiarella* phrases the fiduciary duty element in terms of corporate insiders' obligation to place the shareholders' welfare before their own.[85] In *Dirks*, the Court referred to the fiduciary duty owed by "temporary" insiders as one owed to "shareholders."[86] Although *Dirks* more flexibly defined who may owe a fiduciary duty, both *Chiarella* and *Dirks* strictly defined who the duty is owed to—namely, shareholders.[87]

The Court's intention to restrict the application of rule 10b-5 will be successful if the class of potential plaintiffs is limited to a corporation's shareholders. This approach is the culmination of the trend to restrictively read rule 10b-5 as demonstrated by *Blue Chip*, which created the actual purchaser-seller rule, and *Santa Fe*, which limited rule 10b-5 to breaches of duty involving fraud. The Court's analysis of rule 10b-5 has narrowed the range of potential plaintiffs in private securities fraud actions to shareholders engaged in transactions with corporate insiders who trade on information received from the corporation.[88] If a restrictive interpretation of *Chiarella* is taken, however, the fiduciary duty principle fails to take into account a substantial category of trading by persons with material nonpublic information: trading by persons outside the corporation with no prior "special relationship" to the corporation or its shareholders.[89]

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85. Chiarella v. United States, 445 U.S. 222, 230 (1980).

86. *Dirks*, 463 U.S. at 655 n.14.

87. *See Task Force Report*, *supra* note 2, at 234-35 (glaring deficiency of *Chiarella* and *Dirks* is limiting fiduciary duty to insiders and shareholders); Langevoort, *supra* note 66, at 34 (fiduciary duty rule applies when any fiduciary buys from or sells to its beneficiary); Phillips & Zutz, *supra* note 14, at 70-71 (duty limited to issuer and its shareholders); Seligman, *supra* note 17, at 1088 (*Chiarella* "emphasized that insider's fiduciary duty ran to corporate stockholders.").

88. Professor Wang suggests that only the party in privity with the inside trading defendant is owed a duty of disclosure and can bring a claim under rule 10b-5. 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, 1270-71 (1981) [hereinafter Wang, *Who Can Sue Whom*]; Wang, *A Cause of Action for Option Traders Against Insider Options Traders*, 101 HARV. L. REV. 1056, 1058 n.12 (1988) [hereinafter Wang, *A Cause of Action for Option Traders*]. Given both the Supreme Court's goal in *Chiarella* of restricting the application of rule 10b-5, and that the case does not directly address private actions, Professor Wang's position is a logical interpretation of the effect of the fiduciary duty principle on private rule 10b-5 claims.

89. *See* Seligman, *supra* note 17, at 1090 ("*Chiarella* and *Dirks* may exonerate outsiders who trade on 'outside' information."); Note, *Outsider Trading—Morality and the Law of Securities Fraud*, 77 GEO. L.J. 181, 189 (1988) (*Chiarella* and *Dirks* do not reach trading in *Carpenter*).

C. *Avoiding the Limitations of* Chiarella *Under the Misappropriation Theory*

The SEC and the lower courts developed the misappropriation theory of liability for insider trading under rule 10b-5 as a response to *Chiarella*'s restrictive approach. Under the misappropriation theory, if persons wrongfully convert or misappropriate material nonpublic information in violation of any fiduciary or other duty of trust and confidence and trade or tip while in possession of that information, they are liable under rule 10b-5. The theory reaches those traders who receive valuable information concerning corporate transactions but who lack the requisite fiduciary duty to trading shareholders for liability under *Chiarella*. The misappropriation theory focuses on the means by which defendants acquire the information rather than the relationship defendants have to the corporation or its shareholders. Originally, the government urged the theory as an alternative basis for liability in *Chiarella*. Notwithstanding the Supreme Court's refusal to consider the misappropriation theory, it is the means by which Congress expanded the private right of action far beyond the limits imposed by *Chiarella*.

The misappropriation theory is based on the concurring and dissenting opinions in *Chiarella*. The government's primary argument in *Chiarella* was that the defendant violated rule 10b-5 by trading while in possession of material nonpublic information.[90] The government argued alternatively before the Supreme Court that the defendant breached a duty to the acquiring corporation, not the selling shareholders, and that this breach violated rule 10b-5.[91] The Supreme Court, however, refused to rely on this theory to uphold Chiarella's conviction because the misappropriation theory had not been presented to the jury.[92]

Nevertheless, five justices indicated varying degrees of acceptance of the theory. In his concurrence Justice Stevens noted that a "legitimate argument" could be made that a person's misappropriation of confidential information could constitute the requisite

90. Chiarella v. United States, 445 U.S. 222, 235 (1980).

91. *Id.*

92. The court noted:

> "The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers. Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, . . . 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 (citations omitted).

"fraud" for a rule 10b-5 violation.[93] In separate opinions, four justices went even further, accepting the misappropriation theory as a legitimate basis for a securities fraud action. Chief Justice Burger's dissent articulated a broad theory that would impose an affirmative disclosure duty on any person who misappropriates information.[94] Indications from a potential majority of the Court that the theory was an acceptable interpretation of "fraud" under rule 10b-5, together with the *Chiarella* majority's refusal to rule on the propriety of the theory, permitted the government to pursue cases based on the misappropriation theory to reach transactions beyond the scope of *Chiarella*'s fiduciary duty requirement.

On the heels of *Chiarella*, the government used the misappropriation theory in a criminal insider trading case before the Second Circuit Court of Appeals. In *United States v. Newman*,[95] the indictment charged Newman, a securities broker, with securities fraud, mail fraud, and conspiracy arising out of his receipt of information misappropriated by employees of Morgan Stanley & Co. and Kuhn Loeb & Co., two investment banks.[96] The information related to proposed acquisitions by the investment bankers' clients, and Newman purchased shares in the target companies. The government drafted the *Newman* indictment to rely on the misappropriation theory left open in *Chiarella*, charging that the defendant aided and abetted violations of "the fiduciary duties of honesty, loyalty, and silence owed to Morgan Stanley, Kuhn Loeb, and clients of those investment banks."[97] Newman, as a tippee, and the employees of the investment banks had, at most, a

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93. *Id.* at 238 (Stevens, J., concurring).

94. The Chief Justice's dissent stated, "[A] person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.* at 240. Justice Brennan concurred in the judgment, but accepted the Chief Justice's position 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." *Id.* at 239. Justice Blackmun's dissent, joined by Justice Marshall, went beyond Chief Justice Burger's position by finding liability for persons who had "*access* to confidential information that the honest investor, no matter how diligently he tried, could not legally obtain." *Id.* at 247 (emphasis in original).

95. 664 F.2d 12 (2d Cir. 1981).

96. *Id.* at 14-15. The information came from E. Jacques Courtois, Jr. and Adrian Antoniu, who were employees of Morgan Stanley from 1972 through 1975, when Antoniu moved to Kuhn Loeb. *Id.* Newman also passed information concerning the transactions to two other persons. *Id.* at 15. The district court dismissed the indictment against Newman, which charged securities fraud, mail fraud, and conspiracy, on the ground that the securities laws did not furnish adequate notice of the prohibited conduct. The mail fraud and conspiracy allegations therefore failed as a matter of law if there was no securities law violation. *Id.* at 14.

97. *Id.* at 16.

fiduciary relationship with the acquiring corporations, whose information had been converted, but they owed no duty of disclosure to the target corporations or their shareholders.

The Second Circuit initially rejected the district court's conclusion that Newman did not violate the antifraud provisions because neither the investment banks nor their clients were purchasers or sellers at the time of the alleged inside trading. The circuit court held that *Blue Chip Stamp's* standing limitation did not apply to suits by the government, whether civil or criminal.[98] Noting that it "need spend little time on the issue of fraud and deceit," the court determined that Newman and his co-conspirators had sullied the employers' reputations and wronged the investment banking clients who did not wish to have a target's stock prices artificially inflated by "purloiners of confidential information."[99] Finally, the court rejected Newman's argument that the fraudulent acts were not "in connection with" a purchase or sale of securities. Relying on the Supreme Court's statement in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[100] that the "in connection with" element includes deceptive practices "touching" the securities, the Second Circuit held that the defendant's "sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies."[101]

The *Newman* court neither analyzed the misappropriation theory nor determined whether it was reconcilable with *Chiarella*'s restrictive approach to rule 10b-5. In fact, by stating that rule 10b-5 does not specifically require "that fraud be perpetrated upon the seller or buyer of securities,"[102] the Second Circuit adopted an analysis distinct from *Chiarella*. *Chiarella* emphasized the "special relationship" necessary before a person may be charged with a fiduciary duty to shareholders; only upon the breach of that duty by a fraudulent act does liability for insider trading arise under the federal securities laws.[103]

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98. The court stated that its concern was the scope of rule 10b-5, not a plaintiff's standing to sue, and that "[i]t is only because the judiciary has created a private cause of action for damages the 'contours' of which are not described in the statute, that standing . . . has become a pivotal issue." *Id.* at 17 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)).

99. *Id.*

100. 404 U.S. 6, 12-13 (1971).

101. *Newman*, 664 F.2d at 18.

102. *Id.* at 17.

103. The Second Circuit's statement in *Newman* concerning the fraud element of rule 10b-5 liability is even more questionable when viewed in light of Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977), in which the Supreme Court held that the mere breach of

Newman signaled the Second Circuit's willingness to jettison at least one part of the "special relationship" test described in *Chiarella* by substituting an employer for the trading shareholders as the party defrauded in rule 10b-5 actions. The misappropriation theory accepted in *Newman* permitted the government to bring rule 10b-5 actions when the fiduciary relationship ran between the defendant, as a tippee, and the corporation whose information had been misappropriated, rather than between the defendant and the shareholders, as required by *Chiarella*.[104] After *Newman*, the government could apply the misappropriation theory in actions against persons who were not insiders of the corporation whose securities were traded.

Three years after *Newman*, the Second Circuit upheld the misappropriation theory in *SEC v. Materia*.[105] The court reviewed an SEC injunctive action against an employee of a financial printer who deciphered the targets of possible tender offers and immediately purchased the targets' stock, earning a profit of over ninety-nine thousand dollars.[106] The court contrasted the requirements for a private 10b-5 cause of action, such as standing and fiduciary duty, with those for a government action, in which the court found the *Chiarella* limitations not applicable. The opinion noted that the requisite fraud for a rule 10b-5 action is present when the defendant's actions breach the integrity of the employment relationship.[107]

Materia sought to interpose *Chiarella*, a criminal case with obvious factual parallels, as a bar to the SEC's civil enforcement action, arguing that a copyholder's fiduciary duty is no greater

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a fiduciary duty in violation of state law without any fraud on the shareholders is not actionable under rule 10b-5. *Id.* at 478. Taken together, *Chiarella* and *Santa Fe* can be read to hold that liability for insider trading under rule 10b-5 occurs only when a breach of a fiduciary duty encompasses a fraudulent act perpetrated on the party directly owed the duty.

104. *See* Warren, *supra* note 14, at 1242-43 (discussing circularity of *Newman*'s analysis of breach of duty element).

105. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

106. *Id.* at 199-200. Materia was a "copyholder" whose job entailed reading drafts of documents aloud to a proofreader. He traded in the stock of four tender offer targets prior to the announcements by the offerors. *Id.* at 199.

107. According to the court:

> Among a financial printer's most valuable assets is its reputation as a safe repository for client secrets. By purloining and trading on confidences entrusted to Bowne, it cannot be gainsaid that Materia undermined his employer's integrity. Accordingly, we are driven to the conclusion that, by his misappropriation of material nonpublic information, Materia perpetrated a fraud upon Bowne.

Id. at 202 (citation omitted).

than the duty of a printer like Mr. Chiarella. The Second Circuit adopted a restrictive view of *Chiarella*, however, essentially finding it applicable only in private rule 10b-5 actions. The court, however, did not explain why *Chiarella* should be limited in such a way. The court simply stated that the fiduciary duty analysis "bears only on the type of questions raised in a private suit for damages . . . ."[108]

The *Materia* analysis is dubious in at least two respects. First, *Chiarella* was a criminal prosecution, not a private civil action. The Supreme Court in *Chiarella* did not restrict its analysis to private actions, as the Second Circuit seems to hold. Second, in *Materia*, the Second Circuit rejected the limiting focus of *Chiarella* by permitting a rule 10b-5 action by the government when no relationship existed between the defendant and purchasers or sellers of the securities, much less a "special" one. The court, however, never specifically addressed this analysis in imposing liability on Materia.

Materia and *Newman* proceeded on the theory that rule 10b-5 is violated by fraudulent acts that affect the integrity and confidentiality of employers when information is not disclosed prior to trading. In *Materia*, that breach of trust was self-evidently related to transactions in the securities of the corporations that retained a financial printer. Therefore, the Second Circuit had little trouble finding that the fraud was "in connection with" the purchase or sale of securities, despite the fact that the breach of duty did not involve selling stockholders.[109] Similarly, the *Newman* court found that the defendant's "sole purpose" in misappropriating the information from investment banks was to trade in the target companies' securities, thereby fulfilling the "in connection with" element for liability under rule 10b-5.[110]

In *United States v. Reed*,[111] the United States District Court for the Southern District of New York refused to limit actions based on the misappropriation theory to insider trading by employees. Instead, the court expanded rule 10b-5 liability to cover a corporate director's son who traded on nonpublic information received from

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108. The defendant's reliance on *Chiarella* was "misplaced" because in SEC enforcement actions there is no issue concerning who is owed a fiduciary duty. *Id.*

109. The court stated that "[t]he information Materia stole has no value whatsoever except 'in connection with' his subsequent purchase of securities. The fraud perpetrated on his employer was part and parcel of a larger design, the sole purpose of which was to reap instant no-risk profits in the stock market." *Id.* at 203.

110. United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981).

111. 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

his father.[112] The district court held that, under *Newman* and *Materia*, a person may violate rule 10b-5 "even if they owed no duty of disclosure to the sellers of the securities involved,"[113] provided there is a breach of a duty of fidelity and confidentiality rooted in a fiduciary or other relationship of trust between the misappropriator and the person or entity owed the duty.[114]

The misappropriation theory achieved its broadest reach in *United States v. Carpenter*.[115] *Carpenter* expanded the theory to cover transactions by persons without any possible "relationship" to either the shareholders or the corporation. Moreover, the information involved was not confidential to the issuer. A *Wall Street Journal* reporter, R. Foster Winans, leaked information to two brokers prior to publication in the "Heard on the Street" column. The scheme netted approximately $690,000.[116] According to *Wall Street Journal* policy, all news was company property and non-public information available in the course of employment was confidential.[117] The Second Circuit found that the breach of the duty of confidentiality and use of the information in trading prior to publication constituted a misappropriation, and therefore the trading violated rule 10b-5. The court noted that *Newman* and *Materia* support the proposition that the misappropriation theory reaches trading by outsiders, those with no pre-existing duty to the corporation or its shareholders, and the court held that the *Wall Street Journal*'s policy of confidentiality imposed a "corollary duty" under rule 10b-5 to disclose information or abstain from trading.[118]

Carpenter marks the misappropriation theory's clear break from *Chiarella*. The opinion focuses not on the relationship between the

112. The defendant purchased call option contracts of Amax Inc. on the basis of information concerning an upcoming merger he had learned from his father, a member of Amax's board of directors. *Id.* at 690-91.

113. *Id.* at 703.

114. *Id.* at 712. *See also* United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990). In *Willis*, the defendant, a psychiatrist, learned about an effort by Sanford I. Weil to become chief executive officer of BankAmerica Corporation from his patient, Weil's wife. *Id.* at 271. Willis purchased BankAmerica stock prior to the announcement of Weil's interest in the company, and made a profit of over $27,000. *Id.* The district court denied Willis' motion to dismiss the indictment, holding that the misappropriation theory applies to breaches of the duty of confidentiality a psychiatrist owes to a patient. *Id.* at 274.

115. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

116. *Id.* at 1026-27.

117. *Id.* at 1026.

118. *Id.* at 1034. The court's rationale is aptly summarized by the statement that "investors are endangered equally by fraud by non-inside misappropriators as by fraud by insiders." *Id.* at 1032 (footnote omitted). The court saw no reason to draw a legal distinction based on the status of the misappropriator's relationship to the trading shareholders.

defendant and the party owed the fiduciary duty, but on whether the conversion of the information for personal gain constitutes a breach of duty. The "corollary" duty under rule 10b-5 that the court imposed on the defendants essentially re-creates the broad possession theory of liability of *Texas Gulf Sulphur*, an approach previously rejected by *Chiarella* and *Dirks*. The abstain-or-disclose duty under *Carpenter* is triggered by the defendant's misappropriation of information and is breached when the defendant uses it in trading.

Carpenter's treatment of the "in connection with" element of a securities fraud violation illustrates how the misappropriation theory expands the reach of rule 10b-5. The Second Circuit accepted the trial judge's finding that the news columns had a "significant market impact" and that investors would not have purchased or sold at the prices they did had the misappropriated information been publicly disseminated.[119] The opinion accepted a "but-for" causation standard, which makes virtually any informational advantage related to a security, including information on the market for the security, automatically "in connection with" a purchase or sale. The misappropriation theory in *Carpenter* effectively reduces the questions in a rule 10b-5 action by the government to whether the inside trader breached a duty in acquiring the information, regardless of the type of information or the defendant's relationship to the corporate issuer, and whether the information has value in the market.

The Supreme Court affirmed the securities fraud convictions in *Carpenter* by a 4-4 vote.[120] Because the Court was evenly divided, it did not discuss the propriety of applying rule 10b-5 when market information is misappropriated from a corporation other than the corporation whose securities are purchased.[121] The breadth of the

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119. *Id.* at 1032 n.9.

120. Carpenter v. United States, 484 U.S. 19 (1987).

121. *Id.* at 24. The Supreme Court unanimously affirmed the convictions for mail and wire fraud, holding that those statutes include confidential business information. *Id.* at 28. Governmental enforcement actions involving trading on market information generated in the news media have not been limited to *Carpenter*. For example, a columnist for *Business Week* recently consented to a permanent injunction and pled guilty to trading on information slated to be released in future issues of the magazine. SEC v. Ruderman, No. 89 Civ. 3569 (S.D.N.Y. filed May 25, 1989), Lit. Rel. No. 12109. The SEC has also filed actions against persons who received information from the printers of *Business Week* prior to the distribution of the issues and who traded in securities discussed favorably in the magazine. SEC v. Dillon, No. H-89-424 Civ. (D. Conn. filed July 11, 1989), Lit. Rel. No. 12157; SEC v. Walters, No. 89 Civ. 5526 (S.D.N.Y. filed Aug. 17, 1989), Lit. Rel. No. 12219.

Second Circuit's decision has provoked extensive criticism.[122] The opinion does not adequately address two issues. First, the information used by the defendants was not corporate information, and neither the reporter nor the *Wall Street Journal* owed a fiduciary duty to the shareholders or any members of the investing public. *Carpenter* cuts the misappropriation theory loose from the limitation of *Chiarella*'s fiduciary duty principle. The Second Circuit found liability under rule 10b-5 when there was no possible relationship between the defendants and the corporations in whose securities they traded. Moreover, *Carpenter* somewhat resurrects *Texas Gulf Sulphur*'s possession theory of liability by imposing a disclosure duty on all persons who wrongfully receive or convert material information relating to an issuer of securities and the market for those securities, regardless of the source of the information.[123]

Second, the fiduciary duty breached in *Carpenter* was an employee's duty of confidentiality to his employer, not a traditional corporate fiduciary duty. It is unclear how the breach of a private employer's confidentiality policies can serve as the predicate for a securities law violation, especially when the duty is not connected to a corporation's nonpublic information or its securities.[124] Moreover, the Second Circuit acknowledged that the *Wall Street Journal* may have been able to trade on the information at issue in *Carpenter* without violating rule 10b-5, and that the duty owed to the newspaper was not owed to the corporation or its sharehold-

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122. *See* Note, *The Supreme Court's Missed Opportunity: Carpenter v. United States*, 11 GEO. MASON U.L. REV. 225, 238 (1988) (*Carpenter* divorces fraudulent act from investing public protected by Exchange Act); Comment, *The Misappropriation Theory: The Wrong Answer to the Chiarella Question*, 32 N.Y.L. SCH. L. REV. 701, 720 (1987) (*Carpenter* stretches rule 10b-5 to cover every breach of duty even when securities only tangentially involved); Note, *Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far?*, 61 ST. JOHN'S L. REV. 78, 103 (1986) (*Carpenter* applies rule 10b-5 regardless of whether defendant has fiduciary relationship with market participants); Note, *United States v. Carpenter: An Inadequate Solution to the Problem of Insider Trading*, 34 WAYNE L. REV. 1461, 1480-81 (1988) (*Carpenter* contradicts *Chiarella* by imposing a parity of information rule).

123. "But one may not gain such advantage by conduct constituting secreting, stealing, purloining or otherwise misappropriating material nonpublic information in breach of an employer-imposed fiduciary duty of confidentiality. Such conduct constitutes chicanery, not competition; foul play, not fair play." United States v. Carpenter, 791 F.2d 1024, 1031 (1986).

124. The court asserted that the *Wall Street Journal*'s confidentiality policy created a "corollary duty" to abstain from trading, *id.* at 1034, but the opinion does not explain the basis for this corollary duty, or how a private employment policy gives rise to a public duty, the violation of which makes one subject to criminal prosecution.

ers.[125] By transforming a private, contractual relationship into a public duty, the Second Circuit allowed the government to enforce the private employer's policies through criminal and civil enforcement actions. This stands in sharp contrast to *Santa Fe*'s refusal to allow private plaintiffs to enforce state corporate fiduciary duties through rule 10b-5 actions.

Carpenter is, however, a logical extension of the misappropriation theory. In *Newman* and *Materia*, the government used the theory to avoid the restrictions of *Chiarella* by pursuing enforcement actions against noninsiders without reference to whether the injured shareholders were owed a duty of disclosure by the trader. The misappropriation theory focuses on the means by which the defendant acquired the information, and whether there was fraud in the acquisition, while the *Chiarella* fiduciary duty principle focuses on the relationship between the defendant and the injured shareholders. The information at issue in *Carpenter* is no different from the information in *Newman* or *Materia* for purposes of the misappropriation theory analysis. In each case, the defendants breached a duty to their respective employers and engaged in securities transactions without disclosing the nonpublic information. Under the misappropriation theory, it is irrelevant whether the information is "corporate" inside information or "outside" information that relates to the market for the securities.

III. THE PRIVATE RIGHT OF ACTION UNDER RULE 10B-5: CONGRESS'S INCOMPLETE ATTEMPTS TO OVERCOME *CHIARELLA*

As discussed above, the Supreme Court did not reconcile the misappropriation theory with *Chiarella's* fiduciary duty analysis in *Carpenter*. The development of the misappropriation theory might not have had as great an impact had it been confined to government enforcement actions. Private parties, however, sought to use the theory as a basis for damage claims against inside traders. The Second Circuit rejected private rule 10b-5 actions based on the misappropriation theory in *Moss v. Morgan Stanley, Inc. & Co.*,[126] despite permitting the government to bring a criminal action on the same facts in *Newman*. *Chiarella* remained a substantial limi-

125. *Id.* at 1033. The court noted that "a reputable newspaper, even if it could lawfully [trade], would be unlikely to undermine its own valued asset, its reputation, which it surely would do by trading on the basis of its knowledge of forthcoming publications." *Id.* It is unclear how this hypothetical conclusion justifies imposing criminal liability on an employee under a statute that arguably does not apply to identical conduct if undertaken by the employer.

126. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

tation on the standing of private parties to bring inside trading cases under rule 10b-5 until 1988, when Congress granted private parties standing to sue based on the misappropriation theory.[127]

Congressional involvement in expanding the rights of private parties has been based more on a desire to correct apparent inequities in the administration of the law than a desire to construct a consistent theoretical basis for private actions. The interplay of Congressional enactments and judicial limitations has created a confusing set of standing rules under which parties trading contemporaneously with the inside trader have standing to sue, while the corporations whose information is used for insider trading do not. This section of the Article reviews the classes of potential private plaintiffs in rule 10b-5 actions, and the standing problems Congress has left unresolved. The Article concludes that the currently existing anomalous structure for private actions should be corrected.

A. The Rights of Equity Owners: Congress Eliminates Chiarella's *Limitations for One Class of Securities*

Owners of common and preferred shares hold a direct interest in the corporation.[128] Under traditional corporate law principles, shareholders are owed a fiduciary duty by the corporation's directors and officers.[129] According to *Blue Chip* and *Chiarella*, stockholders that buy or sell shares have the requisite direct relationship with corporate insiders, and have standing to sue those insiders that breach a duty by trading on the corporation's material nonpublic information. *Dirks's* expansion of the category of insiders subject to the disclosure duty of corporate fiduciaries to include investment bankers and lawyers permits equity owners to reach beyond traditional corporate fiduciaries to sue certain outsiders who trade on corporate information.

Chiarella's fiduciary duty principle, however, severely limited which plaintiffs could sue for rule 10b-5 violations. If the information was held by a nonfiduciary, such as an investment banker advising on a hostile tender offer for a target corporation, that investment banker owed no fiduciary duty to the target's share-

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127. Congress gave options traders standing to bring insider trading claims in ITSA four years earlier, although it did not specifically adopt the misappropriation theory as a basis for liability. *See infra* text accompanying notes 201-09.

128. FLETCHER CYC. CORP. § 5083 (perm. ed. 1986).

129. Chiarella v. United States, 445 U.S. 222, 228 n.10 (1980).

holders, and hence was not a "temporary" insider under *Dirks*.[130] Indeed, the information did not belong to the target corporation, and the use of that information in trading the target's stock did not breach any duty owed to the corporation or its owners.[131]

1. The Tangled Web of Rule 10b-5 Case Law: *Moss v. Morgan Stanley Inc.* and Contemporaneous Traders

In *Moss v. Morgan Stanley Inc.*,[132] shareholders of a target corporation sued an employee of an investment banking firm that advised a potential offeror for insider trading in the target's stock prior to the announcement of the tender offer.[133] The transaction at issue in *Moss* was one of the transactions involved in the criminal indictment in *Newman*, in which the Second Circuit adopted the misappropriation theory as a valid basis for a criminal rule 10b-5 prosecution. Faced with a private cause of action, however, the court refused to find that the offeror's investment bank owed a fiduciary duty to the target's shareholders and flatly

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130. *See* SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984). In *Musella*, a law firm office manager tipped the defendants concerning upcoming tender offers and corporate reorganizations involving the law firm's clients. The court rejected the SEC's contention that there was a breach of a fiduciary duty under *Chiarella* giving rise to a rule 10b-5 violation. The court stated:

> The rather anomalous result of the Supreme Court's holding in *Chiarella*, . . . at least from a policy perspective, is that an individual who obtains material nonpublic information regarding a tender offer from the acquiring company, rather than from the target company, is not subject to liability —at least under the *Chiarella* rationale — if he or she chooses to capitalize on this information by trading in the target company's securities.

Id. at 436. The court found the defendants liable, however, under the misappropriation theory. *Id.* at 438-39. *See also Moss*, 719 F.2d at 14 (investment banker representing acquiring corporation does not owe a fiduciary duty to target corporation).

131. In Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980), the Second Circuit rejected a 10b-5 claim by a shareholder who alleged that Morgan Stanley & Co. was a fiduciary of a potential target corporation. The investment banker had been retained to advise another corporation about a possible offer. The "inside information" related to information received during confidential negotiations with the target, after which Morgan Stanley & Co. acquired the shares. The court held that the investment bank received the information as a result of arms length bargaining, not from a fiduciary relationship with the target. *Id.* at 798. The court further held that one does not become a target corporation's fiduciary solely upon receipt of confidential information. *Id.* at 799.

132. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

133. The plaintiffs in the private class action were shareholders of Deseret Pharmaceutical Company who sold shares, prior to the announcement of a tender offer by Warner-Lambert Corporation, at a premium of $10 per share. *Id.* at 8. Morgan Stanley served as an adviser to Warner-Lambert. A member of the investment banker's mergers and acquisitions department tipped others, who purchased 11,700 shares of Deseret Pharmaceutical immediately before the announcement. *Id.*

rejected the argument that private parties could sue for insider trading violations based on *Newman*'s misappropriation theory.[134]

The Second Circuit never satisfactorily explained why private rule 10b-5 claims are not cognizable under the misappropriation theory. Instead, the court tersely stated that "[n]othing in our opinion in *Newman* suggests that an employee's duty to abstain or disclose with respect to his employer should be stretched to encompass an employee's duty of disclosure to the general public."[135] *Moss*, therefore, became a barrier to private rule 10b-5 actions for those injured stock purchasers or sellers who could not otherwise establish the existence of a fiduciary relationship with the defendant.

A corollary standing issue beyond the scope of *Chiarella* and *Dirks* is present in 10b-5 actions: which shareholders, if any, who traded the issuer's securities can recover under rule 10b-5? Appellate courts were originally split on this question. Some courts held that any purchaser or seller of the shares subject to the fraudulent trading could sue, but others ruled that only those who traded directly with the inside trader could recover damages. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[136] a case decided long before *Chiarella*, purchasing shareholders sued a broker and its customers for selling shares prior to the public announcement of a negative earnings report. The broker received the information from a corporate client and leaked it to a group of institutional investors. The investors sold approximately 165,000 shares of the security at issue over the three days prior to the release of the information.[137] In determining whether the broker and its clients owed a duty to the plaintiff shareholders, the Second Circuit stated that the duty runs "not only to the purchasers of the actual shares sold by defendants (in the unlikely event they can be identified) but to all persons who during the same period purchased . . . stock in the open market with knowledge of the material inside information."[138] The court specifically rejected privity as a prerequisite for private rule 10b-5 actions because all persons in the market are affected adversely by such inside trading, not just those

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134. *Id.* at 13. The Second Circuit adopted the district court's holding that private plaintiffs cannot "piggyback" on an employee's fiduciary duty to the employer as the basis for a rule 10b-5 claim. *Id.* (quoting Moss v. Morgan Stanley, Inc., 553 F. Supp. 1347, 1353 (S.D.N.Y.), *aff'd*, 719 F.2d 5 (2d. Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

135. *Id.*

136. 495 F.2d 228 (2d Cir. 1974).

137. *Id.* at 231-32.

138. *Id.* at 237.

who fortuitously trade with the defendant.[139] The opinion did not, however, discuss the limitations applicable in determining what constitutes the "same period" in private party claims.

Two years later, and still before *Chiarella*, the Sixth Circuit adopted a more restrictive privity requirement for private inside trading claims in *Fridrich v. Bradford*.[140] *Fridrich* involved purchases by defendants who received nonpublic information concerning tender offer negotiations. The defendants acquired their stock in late April 1972 and the information was publicly disclosed on June 29, 1972. Two plaintiffs purchased in May 1972 and the others had acquired the stock five years earlier.[141] The court rejected *Shapiro*'s approach permitting recovery for all persons who traded during the same period as the defendants, holding instead that the defendants did not cause any injury to plaintiffs with whom they did not deal directly.[142] The decision avoided the overwhelming damages that defendants could face if they were liable to all persons on the other side of transactions in the security on impersonal markets.[143]

In a widely noted concurrence, Judge Celebrezze proposed limiting the class of plaintiffs in insider trading cases to those trading "contemporaneously" with the defendant. Contemporaneous traders would be owed a duty of disclosure by the insider because they were directly affected by the fraudulent transactions, even in trading on an impersonal market.[144] The concurrence fails, however, to define "contemporaneous," noting only that "[w]hen the insider ceases trading, the informational imbalance ends and the market returns to its normal state."[145]

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139. *Id.* at 239. In Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980), the court limited the defendant's liability for inside trading to the gain realized, because requiring the defendant to compensate all persons trading at the time of the violation would impose liability "out of all proportion to the wrong committed." *Id.* at 170-72.

140. 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

141. *Id.* at 309-11.

142. *Id.* at 320. The Sixth Circuit reasoned that the defendants had not induced the plaintiff's sales, and that there was no relationship between them because the transactions were executed on an impersonal market. *Id.* In rejecting the private party claims, the court noted that the remedies available to the government and private parties under rule 10b-5 need not be coextensive when allowing private claims would lead to "an unjust and unworkable result." *Id.*

143. The majority opinion notes at the outset that one defendant only purchased five shares, earning a profit of less than $53.00. The court stated that its decision was to avoid "Draconian liability" by limiting private rule 10b-5 actions. *Id.* at 308-09.

144. *Id.* at 326-27.

145. *Id.* In Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981), the court adopted Judge Celebrezze's position, stating that "[a]ny duty of disclosure is

2. Congress Creates a Private Right of Action Based on the Misappropriation Theory

Congress eliminated the restrictive standing requirements imposed on private stockholders in rule 10b-5 actions for insider trading in the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA).[146] Section five of ITSFEA created a new Section 20A of the Securities Exchange Act of 1934.[147] Section 20A provides that persons trading on material nonpublic information are liable to persons trading "contemporaneously" in "securities of the same class."[148] Liability, however, is limited to the amount of the profit or loss avoided, less any amounts disgorged in connection with SEC civil enforcement actions.[149]

Although Section 20A creates an express cause of action against inside traders, the Act does not define the term "contemporaneous." The House Report accompanying the Act states, "The bill does not define the term 'contemporaneous,' which has been developed through case law."[150] The House Report cites three decisions in a footnote, *Wilson v. Comtech Telecommunications*,[151] *Shapiro v. Merrill Lynch, Pierce Fenner & Smith Inc.*,[152] and *O'Conner & Associates v. Dean Witter Reynolds, Inc.*,[153] as examples of cases that have applied a contemporaneous trader rule.[154] None of the cited cases, however, provide any guidance for deter-

owed only to those investors trading contemporaneously with the insider; non-contemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information." *Id.* at 94-95.

146. Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified in scattered sections of 15 U.S.C.).

147. 15 U.S.C. § 78t-1 (1988).

148. *Id.* Section 78t-1(a) states:

> Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.

149. *Id.* § 78t-1(b)(1) to (2).

150. INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. No. 910, 100th Cong., 2d Sess. 27, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6064 [hereinafter HOUSE ITSFEA REPORT].

151. 648 F.2d 88 (2d. Cir. 1981).

152. 495 F.2d 228 (2d. Cir. 1974).

153. 559 F. Supp. 800 (S.D.N.Y. 1983).

154. HOUSE ITSFEA REPORT, *supra* note 150, at 27 n.22.

mining the meaning of "contemporaneous" beyond the factual conclusion in each decision. The courts that have considered the issue have not agreed on a principle for determining when the period of contemporaneous trading opens and closes.[155]

The congressionally-created private cause of action for an uncertain class of potential claimants will require courts to expend considerable effort to determine the preliminary issue of who is eligible to sue before reaching the question of liability. Moreover, Congress ceded to the courts virtually complete discretion to define the class of contemporaneous traders, which, in turn, may lead to inconsistent results. A court adopting a restrictive approach can interpret "contemporaneous" to include only persons trading during the same hour or on the same day if the trading occurs, as it frequently does, over a period of time, while another court may adopt a more expansive approach.[156]

Congress limited potential liability to contemporaneous traders by restricting the amount of damages to the defendant's gain or loss avoided. Nevertheless, the damage limitation does not rectify the problem of determining who may take advantage of the private right of action. By limiting damages, Section 20A lessens the incentive for private parties to sue because the amount of damages sustained by individuals is likely to be small compared to the class of contemporaneous traders. Thus, what appears to be a broad grant of a private cause of action in Section 20A is a right that may be narrowly interpreted and may allow only a negligible recovery compared to the loss suffered by contemporaneous traders.

By restricting liability to purchasers or sellers of securities of the "same class," Section 20A does not extend the inside's liability to claims by persons transacting in *all* securities related to the corporation that may be affected by the trading, such as market index securities that include the corporation in the basket of stocks tracked by the index. Section 20A does expand liability, however,

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155. Wang, *The "Contemporaneous" Traders Who Can Sue an Inside Trader*, 38 HASTINGS L.J. 1175, 1178-84 (1987). Professor Wang reviewed the various time periods for which courts consider trading to be contemporaneous with the inside trader. He noted that "[t]rading one month after the inside trade is too long; unclear is whether a day or even an hour also would be too long." *Id.* at 1177.

156. In Backman v. Polaroid Corp., 540 F. Supp. 667 (D. Mass. 1982), the court found that sales of stock made two and seven trading days after the insider's transaction were "outside of the period of insider trading," but sales of call options on the same day as the insider's transaction could be pursued. *Id.* at 671. In *O'Conner & Associates*, 559 F. Supp. at 802, the court allowed class claims covering five trading days during the period the defendants purchased call options.

to cover securities that previously may not have been subject to private rule 10b-5 actions, such as corporate bonds.[157]

More important than expressly codifying a private cause of action for contemporaneous traders, Congress expanded the class of plaintiffs who can bring claims against inside traders. The House Energy and Commerce Committee expressly rejected *Moss v. Morgan Stanley Inc.* and granted contemporaneous traders the right to rely on the misappropriation theory for private insider trading actions. According to the House ITSFEA Report, *Moss* "is inconsistent with the remedial purposes of the Exchange Act," and the misappropriation theory is an appropriate basis for rule 10b-5 actions against inside traders.[158] After reviewing the history of insider trading cases and noting the limitations of *Chiarella* and *Dirks* and the development of the misappropriation theory, the Report concluded that the conduct at issue in *Carpenter* "should be encompassed within Section 10(b) and Rule 10b-5."[159] By endorsing *Carpenter*, Congress approved the broadest application of the misappropriation theory. Moreover, Congress's explicit rejection of *Moss* extends to private plaintiffs a right to pursue claims for insider trading that is coextensive with the government's right to sue. Section 20A allows private claims against any person whose trading on wrongfully converted information violates the federal securities laws, regardless of whether the defendant is a corporate fiduciary under *Chiarella*.

Section 20A renders *Chiarella* superfluous for many private insider trading cases because plaintiffs need not prove they have a direct relationship with the transacting defendants. Instead, defrauded purchasers or sellers must demonstrate only that their trading was contemporaneous with the defendant's and that the defendant acquired the material nonpublic information by breaching some fiduciary or other duty of trust and confidence.

Section 20A endorses the misappropriation theory developed by the courts. Congress enacted a legal theory of liability, however, that only vaguely specifies what conduct triggers rule 10b-5. The misappropriation theory requires a breach of duty, but the courts have not specified all relationships giving rise to duties that, if breached, form the basis for liability. Thus far, employment and familial relationships have been the basis for the breach of duty element in governmental rule 10b-5 actions. That does not, how-

157. *See infra* text accompanying notes 224-25 (discussing bondholders' standing to bring insider trading claims under § 20A).

158. HOUSE ITSFEA REPORT, *supra* note 150, at 26.

159. *Id.* at 10.

ever, exhaust the range of relationships involving a duty of trust and confidence that may be breached in acquiring inside information. Section 20A, therefore, grants private parties the right to pursue claims based on a theory in which a key component has only partially been articulated. As a result, Congress has elevated a developing concept into a basis for expanded civil liability without providing any clear guidelines for that development.[160]

B. Options Trader Standing: An Incomplete Remedy

Section 20A is not limited to transactions in common stock, but permits a claim against inside traders by all persons trading con-

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160. The House ITSFEA Report notes that "the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law." *Id.* at 11. Congressional failure to provide any guidance, however, means that those persons whose conduct does not fall within those "clear guidelines" will continue to risk civil and criminal liability, without any fair warning that their actions violated rule 10b-5.

One interesting aspect of the Congressional expansion of private rights of action is that individuals can now bring claims under § 20A to the same extent as the government. Nevertheless, the government relies on the misappropriation theory, a judicial interpretation of rule 10b-5, which received only tenuous support from the Supreme Court in *Carpenter*. Despite Congressional enshrinement of the misappropriation theory for private claims in ITSFEA, the Supreme Court could decide that, as presently drafted, rule 10b-5 only permits actions by the government when there is a breach of a fiduciary duty within the meaning of *Chiarella*. Or, the Court could adopt a more limited approach and force the government to abandon the misappropriation theory in cases factually similar to *Carpenter*, when there is no corporate information or "temporary" insider involved in the transactions.

If the Supreme Court were to restrict the misappropriation theory as a basis for rule 10b-5 actions, an anomalous situation could result. If § 20A provides an independent right of action for insider trading, then private parties would be able to rely on § 20A to bring actions based on the misappropriation theory, which has been developed in governmental enforcement actions, without reference to any potential limitations the Supreme Court may impose on the application of the misappropriation theory in rule 10b-5 actions. The government, however, could not pursue the same case if the Supreme Court were to limit the use of the theory in rule 10b-5 actions. For example, if the Supreme Court prohibits rule 10b-5 actions against non-insiders trading on market information, such as the information at issue in *Carpenter*, contemporaneous sellers of the common stock could sue under § 20A because the defendant traded on material nonpublic information that had been misappropriated. The SEC, however, would be precluded from bringing a civil enforcement action. The only possible criminal liability would be for mail or wire fraud.

By focusing on the rights of private parties in ITSFEA, Congress has created the odd prospect that private parties conceivably may have greater power through § 20A than the government has under rule 10b-5 to enforce the antifraud provisions of the securities laws. Congressional action would become necessary to correct the potential imbalance in the rights of the government and private parties, by either amending rule 10b-5 to include the misappropriation theory, or restricting private rights to conform to the government's power to enforce the securities laws. Given the Congressional enthusiasm for the misappropriation theory, the former course appears to be the more likely result.

temporaneously in the "same class" of securities. The securities subject to Section 20A include stock options and market index options. Derivative securities are widely traded on national exchanges, and stock options of a corporation are frequently a vehicle for transactions by persons with inside information.[161] Derivative securities, however, fall outside the traditional category of equity securities, and *Chiarella's* fiduciary duty requirement, which focuses on the duty owed to shareholders, created a loophole in rule 10b-5's coverage of options.[162] Prior to the passage of Section 20A in 1988, Congress sought to close the loophole by granting options traders standing to bring insider trading claims under rule 10b-5. Nevertheless, *Chiarella* continued to affect the analysis of rule 10b-5 claims by options traders, and Congressional and judicial treatment of derivative securities has created uncertainty regarding options traders' standing to bring rule 10b-5 actions.

1. *Chiarella's* Effect on Options Trader's Standing to Sue for Insider Trading Violations

A stock option is a contract granting the holder of the option the right to purchase (call) or sell (put) the underlying security in a trade with the party on the other side of the contract, the writer or seller of the option.[163] Unlike a futures contract, which is a binding agreement to deliver an item on the contract settlement date, an option gives the holder the right, but not the duty, to exercise the contract and buy (or sell) the security at any time prior to the contract's expiration.[164] Common stock option contracts, which usually represent one hundred shares of the underlying security, are traded publicly on national exchanges.[165]

Stock option contracts are "derivative" in the sense that their value is based on the underlying security. The price of common

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161. *See, e.g.*, SEC v. Tome, 638 F. Supp. 596, 610 (S.D.N.Y. 1986), *aff'd*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied*, 486 U.S. 101 (1988) (defendants purchased 1855 out-of-the-money call option contracts immediately prior to announcement of hostile tender offer); United States v. Reed, 601 F. Supp. 685, 690-91 (S.D.N.Y.) (defendant purchased 500 out-of-the-money call option contracts prior to a merger announcement), *rev'd*, 773 F.2d 477 (2d Cir. 1985). Reed was acquitted after trial. Berton, *Reagan Ex-Adviser Cleared of Charges of Insider Trading*, Wall St. J., Dec. 17, 1985, at 12, col. 2.

162. *See* Langevoort, *supra* note 66 at 42 (narrow reading of *Chiarella* creates a loophole in applying rule 10b-5 to options); Wang, *Who Can Sue Whom*, *supra* note 88, at 1286 (no fiduciary duty owed to seller of call option under *Chiarella*).

163. Fabozzi, *Introduction to Option Contracts*, in HANDBOOK OF FINANCIAL MARKETS: SECURITIES, OPTIONS AND FUTURES, 549-50 (2d ed. 1986).

164. *Id.* at 550.

165. *Id.* at 551.

stock options incorporates the intrinsic value, the difference between the price of the underlying security and the exercise price, and the premium, an amount over the intrinsic value that investors will pay based on the option's time value, the volatility of the market, and the demand for the option. Each option contract has an expiration date and a strike price, the price at which the underlying security will be traded if the option is exercised prior to expiration. The issuer of the underlying security does not issue the options and does not control the number of options available in the market. Instead, listed options are issued and guaranteed by the Options Clearing Corporation (OCC), which serves as an intermediary between purchasers and sellers in settling contracts and making payments; therefore, the contracting parties never deal directly with each other.[166]

Prior to 1973, options were sold only in the over-the-counter market in negotiated, face-to-face transactions. At that time options did not have standardized terms. The SEC authorized experimental trading of options on the Chicago Board of Exchange in April 1973.[167] An SEC study noted that:

> [t]o those who understand . . . [options], they may offer an alternative to short term stock trading at lower commission costs and a smaller commitment of capital . . . [and] also provide a means for shifting the risk of unfavorable short term stock price movements from owners of stock who have, but do not wish to bear, those risks, to others who are willing to assume such risks in anticipation of possible rewards from favorable price movements.[168]

Unfortunately for those trading in the options market, *Chiarella*'s fiduciary duty analysis created a substantial, albeit unintended, loophole in the law of insider trading. The parties trading in options have no direct relationship to the corporate issuer of the underlying common stock because the OCC, not the corporation, is the issuer of the option contract. Thus, there is no fiduciary relationship between the purchaser and the writer or seller of the option.[169]

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166. Seligman, *The Structure of the Options Market*, 10 J. CORP. LAW 141, 145-46 (1984).

167. In re Chicago Board Options Exchange, Inc., Exchange Act Release No. 9985, [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,212 (Feb. 1, 1973).

168. STAFF OF HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 96TH CONG. 1ST SESS., REPORT OF THE SPECIAL STUDY OF THE OPTIONS MARKETS TO SECURITIES AND EXCHANGE COMM. 1 (Comm. Print 1978).

169. *See* Seligman, *supra* note 166, at 145 ("In a formal sense, the OCC issues each option. The holder of the option looks to the OCC, and not an individual writer, for performance in the event the option is exercised.").

The options trader may arguably be an "incipient" shareholder, similar to a purchaser of stock who acquires the security while an insider is selling but who does not have a pre-existing relationship with the corporation.[170] Most option contracts, however, are not exercised, and the contract does not require that the party to the contract acquire or dispose of the shares. The options trader does not enter into a relationship with the corporation when the derivative security is traded. Although *Chiarella* imposes the formalistic requirement of a pre-existing fiduciary duty before liability attaches for insider trading under rule 10b-5, options traders do not have such a fiduciary relationship. Therefore, trading in options while in possession of material nonpublic information does not breach a disclosure duty under *Chiarella*.[171]

The arbitrariness of the fiduciary duty analysis in the context of options becomes clear when a corporate insider, such as a director, receives information about an impending offer for the company and purchases out-of-the-money call options prior to the announcement of a tender offer at a price above the option strike price. The value of the option is based on the underlying stock price, and the cost of acquiring out-of-the-money call options is only the small amount of the premium. If the common stock price then moves above the strike price in response to the offer, the value of the option will increase accordingly. The potential profits from such a transaction can be enormous[172] because options are significantly less expensive than acquiring the equivalent number of shares. Under *Chiarella*, however, the seller of the call options could not sue the insider because, although the director clearly breached a fiduciary duty to the corporation, the director did not owe that fiduciary duty to the option writer.

A corollary issue is whether an options trader can sue an insider trading in the underlying securities. The argument in favor of allowing such a suit is that, because options are derivative and transactions in the stock affect the value of the options, options

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170. *See* Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961) ("We cannot accept [the] contention that an insider's responsibility is limited to existing shareholders and that he has no special duties when sales of securities are made to non-stockholders.").

171. *See* Langevoort, *supra* note 22, at 1290 n.82 (no fiduciary relationship exists prior to exercise of option).

172. For example, in United States v. Reed, 601 F. Supp. 685, 691 (S.D.N.Y.), *rev'd*, 773 F.2d 777 (2d. Cir. 1985), the defendant purchased 500 out-of-the-money March 50 call option contracts for the common stock of Amax Inc., at a total cost of $3,346.76, the day before Amax announced it would be taken over in a friendly merger. After the announcement, the value of the options rose dramatically, and the defendant sold the contracts at a profit of approximately $431,000, a healthy return on a two-day investment.

traders should not be treated differently from shareholders when they have been harmed by violations of rule 10b-5.[173] In *Laventhall v. General Dynamics Corp.*,[174] the Eighth Circuit considered a securities fraud suit filed by a seller of call options who claimed the defendant corporation's purchases of common stock prior to the announcement of a stock split and dividend violated rule 10b-5. The court held that, under *Chiarella*, there is no relationship of trust and confidence between options traders and the corporate issuer of the underlying securities, and therefore holders of the options may not bring a private 10b-5 action.[175] *Laventhall* further held that plaintiffs must show a "transactional nexus" between their trading and the defendant's trading to prove that they suffered a loss traceable to the inside trading.[176]

By adopting the "transactional nexus" test for standing, the Eighth Circuit limited the plaintiff class to those traders directly harmed by the use of the inside information without requiring that the plaintiffs prove they were in privity with the defendant. The plaintiffs in *Laventhall*, as options traders, were only indirectly affected by the defendant's stock purchases, and "[t]he defendant's alleged illegal gain [was] remote and totally speculative in relation

173. *See* Langevoort, *supra* note 66, at 42 (little basis for distinguishing options and equity markets for disclosure purposes); Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959, 1964 (1987) (option holders deserve compensation, and damages should be allocated pro rata between stock and options traders) [hereinafter Note, *Option Investors*]; Note, *Securities Regulation for a Changing Market: Option Trader Standing Under Rule 10b-5*, 97 YALE L.J. 623, 638-39 (1987) (shareholders and options traders have same functional relationship to corporation and insider trading affects both markets) [hereinafter Note, *Option Trader Standing*].

174. 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983).

175. *Id.* at 411-12 ("There simply existed no relationship of trust and confidence between the parties."). One commentator criticized *Laventhall*'s reliance on *Chiarella* to limit the plaintiff class in rule 10b-5 actions, asserting that the fiduciary duty principle only limits the defendant class, and that if one is an insider under *Chiarella*, the person is liable for any trading on nonpublic information. Note, *Laventhall v. General Dynamics Corporation: No Recovery for the Plaintiff-Option Holder in a Case of Insider Trading under Rule 10b-5*, 79 NW. U.L. REV. 780, 787-88, 794-95 (1984). The author argues that options traders are "like the *purchaser* of a stock," and therefore are owed a duty of disclosure by insiders. *Id.* at 796 (emphasis in original).

Chiarella held that there must be a duty of disclosure arising from a relationship of trust and confidence between parties to a transaction before liability for insider trading could arise. Although *Chiarella* is a criminal case, not a private rule 10b-5 action, the Supreme Court's analysis is clear that the fiduciary duty must run between two parties, one of which must be the corporation. Defendants who simply are trading the corporation's securities are not automatically liable to any person for violation of rule 10b-5.

176. *Laventhall*, 704 F.2d at 412.

to the plaintiff's loss in a different market . . . ."[177] The court's decision was colored by its view of options, which do "not represent contribution of capital to the corporation," and its view that the options market is only indirectly affected by transactions in the common stock.[178]

Laventhall correctly applied *Chiarella* because the fiduciary duty principle excludes standing for options traders, who do not have any relationship of trust and confidence with the corporation or its insiders at the time of the transaction in the derivative security.[179] The Eighth Circuit did not, however, need to move beyond the *Chiarella* duty analysis to consider whether the plaintiff suffered any loss to decide the case. The court's assertion that options traders cannot show a "transactional nexus" with the defendants ignores the economic reality that options are derivative securities whose value is directly affected by transactions in the underlying security. *Laventhall* assumed that "[h]ad plaintiff been contemporaneously trading in the same market, that is, buying and selling common stock at the same time defendant was trading," then a "transaction nexus" existed because the plaintiff could trace a loss to the inside trading.[180] If trading stockholders suffer a loss,

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177. *Id.*

178. *Id.* at 411. The court concluded that the parties "in no way can be said to have been 'trading' with one another." *Id.* at 414.

179. Despite *Chiarella's* limiting effect on private party standing for inside trading cases, the United States District Court for the Southern District of New York, in O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981) (*O'Connor I*), permitted an options seller to sue tippee-purchasers of options for violation of rule 10b-5 in the same transaction at issue in United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.) *rev'd*, 773 F.2d 477 (2d Cir. 1985). Although the *O'Connor I* court noted that an options trader has no fiduciary relationship with the corporation, it held that a private party can sue under the misappropriation theory when the defendants transacted in options rather than common stock. *O'Connor I*, 529 F. Supp. at 1185.

O'Connor I was decided before the Second Circuit barred private actions based on the misappropriation theory in Moss v. Morgan Stanley, Inc., 719 F.2d 5 (2d Cir. 1983), *cert. denied* 465 U.S. 1025 (1984). Nevertheless, the court in O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 600 F. Supp. 702 (S.D.N.Y. 1985) (*O'Connor II*), permitted the plaintiff to continue the suit after *Moss* because it determined that *Moss* did not apply. *O'Connor II*, 600 F. Supp. at 704-05. The *O'Connor II* court distinguished *Moss* on the basis that the information in that case did not come from an insider of the target, while the information in *O'Connor I* was alleged to have come from corporate insiders. *Id.* at 704. The Court's attempt to distinguish *Moss* on its facts is specious because the status of the tipper is irrelevant to the analysis of the fiduciary relationship of options traders to the corporation. The misappropriation theory was squarely rejected in *Moss* for all private claims. *Moss*, 719 F.2d at 16.

180. Laventhall v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir. 1983).

however, options traders on the same side of the transactions will also be affected, an economic fact *Laventhall* ignored.[181]

2. Options Trader Standing to Sue for Material Misstatements: A Misapplication of *Chiarella*

Courts may be averse to permitting options traders to sue for violations of rule 10b-5 because many view options as risky, inherently speculative investments that are unrelated to the traditional function of equity securities as a source of capital for the issuer.[182] This view, coupled with the fiduciary duty analysis of *Chiarella*, has prompted some courts to deny options traders standing to bring rule 10b-5 claims for affirmative misstatements by corporations and their officers and directors that affect the value of its securities. Allegations of material misstatements involve issues distinct from insider trading claims under rule 10b-5. The key issues in misstatement cases are the materiality of the statements, and, in some instances, whether there is a duty to provide additional information to clarify misleading or incomplete original statements. Unlike insider trading cases, these securities fraud actions involve an affirmative corporate act. There is no question that the corporation owes a duty of disclosure to its shareholders. Nevertheless, some courts misapply *Chiarella* and deny standing to options traders in misstatement cases.

The United States District Court for the Northern District of Illinois refused to allow options traders to sue under rule 10b-5 for alleged misstatements in *Bianco v. Texas Instruments, Inc.*[183] The misstatements concerned optimistic earnings projections, while in fact the issuer suffered a decline in demand for its product. Relying on *Chiarella* and *Laventhall*, the court dismissed the claim, holding that options are too remote to meet the "in connection with" element of rule 10b-5 "when the alleged deceptive acts are merely corporate misstatements not directed in any way to the

181. *See* Fabozzi, *supra* note 163, at 555 (cost to buyer of option primarily reflects the intrinsic value and any excess over intrinsic value); Note, *supra* note 175, at 805 n.135 ("The relevant point for the *Laventhall* case is that the stock price figures in the options price.").

182. *See Laventhall*, 704 F.2d at 410-11 ("It is fundamental for our understanding that the purchase of the options did not represent contribution of capital to the corporation."). One district court went so far as to characterize the derivative market as the "options trading game." Data Controls North, Inc. v. Financial Corp., Inc., 688 F. Supp. 1047, 1050 (D. Md. 1988), *aff'd*, 875 F.2d 314 (4th Cir. 1989).

183. 627 F. Supp. 154 (N.D. Ill. 1985).

options market."[184] The court drew no distinction between affirmative misrepresentation claims and insider trading actions, which entail a failure to disclose, determining instead that *Chiarella*'s fiduciary duty principle applied to all rule 10b-5 actions.[185]

In *Starkman v. Warner Communications, Inc.*,[186] the United States District Court for the Southern District of New York also rejected a suit by options traders for affirmative misstatements, relying on *Chiarella* and *Laventhall.* Although the district court noted that misstatements affecting the common stock's price also affect options, it stated that "options trading is recognized as inherently more risky than investing in shares and an investor chooses which risk/return strategy to follow."[187] Similarly, in *Data Controls North v. Financial Corp.*,[188] the United States District Court for the District of Maryland adopted the "more widely-held view" by refusing to permit options traders to sue under rule 10b-5 for alleged misstatements and omissions, stating that it was "not prepared to extend this right to those who engage in risky speculation such as that found in the options trading game."[189]

It is unclear why courts apply *Chiarella* to noninsider trading cases. Equally unclear is why courts focus on the speculative nature of the options market to justify denying options traders recovery in affirmative misrepresentation cases. Insider trading cases involve

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184. *Id.* at 161. Interestingly, the court permitted the options traders to sue an alleged tippee that purchased options, despite the lack of a fiduciary relationship between the plaintiffs and the corporation. *Id.* at 163-64.

185. *Id.* at 161. The court stated that it would not extend liability under rule 10b-5 to options traders because options contracts are a "riskier investment," and the corporation does not control the number of options available in the market. *Id.* Unfortunately, the opinion fails to explain why the degree of risk in options trading or the power of investors to write option contracts outside the underlying issuer's control influences whether the antifraud provisions apply to claims by options traders for injury caused by the corporate defendant. Apparently, the court assumed that part of the risk undertaken by options traders includes the risk of material misstatements by the corporation, even though rule 10b-5 does not distinguish between different classes of securities or allow fraud to be perpetrated on a particular class of securities.

186. 671 F. Supp. 297, 301-04 (S.D.N.Y. 1987). The plaintiffs were options traders who opted out of a class action settlement related to rule 10b-5 claims involving Warner Communication's disclosure of losses from its video games division. *Id.* at 299.

187. *Id.* at 307. According to the court, "[o]ptionholders should not, and presumably do not, expect that management owes them obligations of disclosure similar to those owed to shareholders." *Id.* at 304-05. The court did not explain the basis for its conclusion that options traders always assume the risk of material misstatements and thereby expose themselves to fraud by choosing to invest in derivative securities.

188. 688 F. Supp. 1047 (D. Md. 1988), *aff'd*, 875 F.2d 314 (4th Cir. 1989).

189. *Id.* at 1050. The allegations involved a failure to fully disclose information concerning the defendant's financial condition. *Id.* at 1048.

nondisclosure of material information, and the law recognizes that a person need not disclose information in the absence of any duty to disclose. If a person or a corporation acts affirmatively to disseminate information, there is a duty "not only to state the truth but also not to suppress or conceal any facts within his knowledge which will materially qualify those stated; if he speaks at all, he must make a full and fair disclosure."[190] The duty between the parties arises because of the affirmative act of communicating information, not on the basis of a prior fiduciary relationship.[191]

Deutschman v. Beneficial Corp.[192] considered an options trader's rule 10b-5 claim for false and misleading statements about losses in one of the defendant's divisions. The district court dismissed the claim based on *Chiarella* and *Laventhall.*[193] The circuit court, however, found that the district court's reliance on *Chiarella* was "entirely misplaced," because *Chiarella* does not require a fiduciary relationship between the parties when the defendant allegedly made an affirmative misrepresentation.[194] The Third Circuit noted that the price of options is closely dependent on the price of the underlying security. Moreover, while options may not play a role in capital formation in the securities market, the court was "not willing to construe section 10(b) as inapplicable to option contracts on the basis of speculation about the relationship between option contracts, market liquidity and capital formation."[195]

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190. First Virginia Bankshares v. Benson, 559 F.2d 1307, 1313 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978); *see* Basic Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988) (an "ever-present duty not to mislead").

191. *See* Rose v. Arkansas Valley Envtl. & Util. Auth., 562 F. Supp. 1180, 1207-08 (W.D. Mo. 1983) (disclosure duty "not because of any independent personalized relationship of trust and confidence between the defendant and the plaintiff, but rather because of the defendant's prior affirmative act of communication."). *Cf.* Rowe v. Maremont Corp., 650 F. Supp. 1091, 1105 (N.D. Ill. 1986), *aff'd*, 850 F.2d 1226 (7th Cir. 1988) (*Chiarella* not sole basis for duty of disclosure).

192. 841 F.2d 502 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 3176 (1989).

193. 668 F. Supp. 358 (D. Del. 1987), *rev'd*, 841 F.2d 502 (3d. Cir. 1988), *cert. denied*, 109 S. Ct. 3176 (1989).

194. 841 F.2d at 506. The court also stated that *Laventhall* was "simply not relevant to the distinct issue of affirmative misrepresentations affecting a market in securities." *Id.* at 507.

195. *Id.* at 507-08. The United States District Court for the Southern District of New York, in In re Gulf Oil/Cities Service Tender Offer Litigation, 725 F. Supp. 712 (S.D.N.Y. 1989), relied on *Deutschman* in rejecting the defendants' claims that options purchasers did not have standing to bring a rule 10b-5 claim for alleged material misstatements in connection with a tender offer. The court further held that options traders have standing to bring claims under § 14(e) of the Williams Act, which prohibits material misstatements or omissions in connection with tender offers, because of the close economic link between the stock and options markets. *Id.* at 744.

The First Circuit followed *Deutschman*'s analysis in *Backman v. Polaroid Corp.*[196] In *Backman*, the plaintiffs were purchasers of common stock and call options for the common stock of Polaroid Corporation. Plaintiffs alleged that the company failed to disclose adverse information concerning sales difficulties after previously disseminating optimistic projections.[197] The circuit court found the reasoning of *Deutschman* "persuasive" in upholding the options trader's right to sue for misrepresentations by the defendant.[198]

Although recent decisions on options traders' standing to sue for affirmative misrepresentations have been split, *Deutschman* and *Backman* provide the better analysis. Rule 10b-5 specifically prohibits untrue statements of material facts or omissions of facts necessary to make statements not misleading. Affirmative misstatements directly affect all classes of an issuer's securities, including options and debt securities. The economic reality that option pricing is derivative of the common stock means options traders

196. Fed. Sec. L. Rep. (CCH) ¶ 94,899, *diff't result on rehearing*, 910 F.2d 10 (1st Cir. 1990).

197. Fed. Sec. L. Rep. (CCH) ¶ 94,899 at 94,939. The plaintiffs alleged that Polaroid buried a reference to "substantial expenses" relating to sales of a new camera in its Third Quarter Report to Stockholders, and that a subsequent news release concerning the sale of a large block of company stock by a foundation controlled by Polaroid's founder failed to disclose the problems with the new camera. *Id.* at 94, 940.

198. *Id.* at 94,955. The court found that *Laventhall's* analysis does not apply to misrepresentation claims under 10b-5. *Id.* at 94, 954. The district court in *Backman* found that options traders had standing to bring a 10b-5 claim, but the court construed the plaintiffs' claim to involve insider trading in connection with the sale of Polaroid stock by the foundation without disclosing the negative information. 540 F. Supp. 667, 669-70 (D. Mass. 1982). The court's opinion did not consider *Chiarella* or how options traders can bring claims for insider trading against defendants trading in a different securities market. The district court's rationale was that options are a "security" under the definition of that term in the Exchange Act, and 10b-5 applies to "any person." *Id.* at 671. The court did note that the options trader plaintiff "may have difficulty in establishing that he was damaged" by the defendant's trading. *Id.* The circuit court in *Backman* stated that the plaintiffs' position below may have reflected an insider trading claim, but on appeal their only argument was that the misrepresentations damaged the plaintiffs. Fed. Sec. L. Rep. ¶ 94,899 at 94,955.

The United States District Court for the District of Massachusetts also followed *Deutschman* in Tolan v. Computervision Corp., 696 F. Supp. 771 (D. Mass. 1988), in permitting a 10b-5 claim for affirmative misrepresentations by options traders. The plaintiffs alleged that the defendant and its officers artificially inflated the stock price through a series of misstatements and omissions concerning operations, earnings, and projected growth. *Id.* at 772. The court held that there is a "fundamental distinction" between fraudulent nondisclosure in inside trading cases and the "broader liability for issuing false and misleading statements because the misrepresenting party can be held liable, even if he did not trade in the security." *Id.* at 775. The court found that option trading "is directly affected by the prospecti, representations and omissions of the issuer of the underlying security." *Id.*

have a significant stake in the fair presentation of information by the corporation, and any affirmative misstatement should give rise to liability under rule 10b-5(b). *Chiarella* does not address the issue of affirmative misrepresentations, and the fiduciary duty principle articulated for insider trading claims should not be expanded to limit standing for other rule 10b-5 claims.

3. Congress Attempts to Close the *Chiarella* Loophole

Congress tried to resolve the problem created by *Chiarella* that apparently allowed persons to trade in options without being subject to rule 10b-5. As part of the Insider Trading Sanctions Act of 1984 (ITSA), Congress added a new Section 20(d) to the Exchange Act, which created a private right of action against persons trading in options while in possession of material nonpublic information, with liability "comparable" to the liability defendants have to shareholders.[199] When Congress passed ITSA, the government was already bringing enforcement actions under the misappropriation theory, thereby avoiding any *Chiarella*-related limitations on claims against insiders trading in options.[200]

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199. 15 U.S.C. § 78t(d) (1988). Section 20(d) provides:

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

15 U.S.C. § 78t(d).

Two commentators who have analyzed the right of options traders to bring private insider trading claims under 10b-5 failed to consider § 20(d) in reaching their conclusion that the purchasers and sellers of options should have standing to sue. Note, *Insiders, Options and the Fiduciary Principle: A Rule 10b-5 Loophole*, 16 FORDHAM URBAN L. J. 295 (1988) [hereinafter Note, *A Rule 10b-5 Loophole*]; Note, *Option Investors*, *supra* note 173, at 1962. *See* Wang, *supra* note 23, at 1056 (discussing failure to properly interpret § 20(d) in Note, *Option Investors*). One commentator's analysis led to the following conclusion:

> The insider may trade options on his company's stock based on . . . material nonpublic information in the same way he might trade the stock itself. The irony is that while he would violate rule 10b-5 for trading stock without disclosing the information, he would not violate the Rule by trading options.

Note, *A Rule 10b-5 Loophole*, *supra*, at 322. On the contrary, the misappropriation theory and § 20(d) impose civil and criminal liability on the insider trading in options.

200. *See supra* text accompanying notes 90-125 (discussing misappropriation theory).

Section 20(d) was added by the Senate as an amendment, and the provision received only minimal attention prior to enactment.[201] Although ITSA was not intended to change existing law, Section 20(d) effectively overturned part of *Chiarella*'s fiduciary duty principle for private options trader claims. While the government had relied on the misappropriation theory to reach defendants transacting in options,[202] private options trading plaintiffs had to prove a relationship of trust and confidence with the insider. Section 20(d) eliminated the requirement that options traders prove the defendant breached a fiduciary duty. Insiders trading in options were liable just as if they had traded in common stock, despite the lack of a fiduciary relationship between the options trader and the underlying corporation.

Section 20(d) elevated options traders to the same position as common stockholders vis-a-vis insiders, at least when the defendant purchased or sold options. The provision did not affect *Chiarella*'s limitation on private rule 10b-5 claims against persons who did not have a fiduciary relationship with the corporate shareholders, and it did not allow options traders to bring claims based on the misappropriation theory. If stock traders would not be liable to shareholders because there was no *Chiarella* relationship, there could be no "comparable" liability to options traders. Section 20(d) did not completely eliminate the *Chiarella* limitation on private rule 10b-5 actions because an options trader still had to show the breach of a fiduciary duty owed to investors. As a result of Section 20(d), however, the duty need not be owed directly to the options trader.

4. The Limit of Options Traders' Standing: Claims Against Insiders Trading in the Underlying Common Stock

In Section 20(d), Congress sought to prevent insiders from circumventing the antifraud provisions by using derivative securi-

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201. The options trader provision was not in the original version of ITSA passed by the House, and the report on the legislation by the House Energy and Commerce Committee does not discuss the new private cause of action. H.R. REP. No. 355, 98th Cong., lst Sess., *reprinted in* 1984 U.S. CODE CONG. & ADMIN. NEWS 2274 [hereinafter HOUSE ITSA REPORT]. The Senate did not submit a report accompanying the legislation, and the only discussion of the options trader provision was in a review of the bill by Senator D'Amato, its Senate sponsor. 130 CONG. REC. S8913 (daily ed. June 29, 1984). The House consideration of § 20(d) was confined to reprinting Senator D'Amato's remarks on the provision. *Id.* at H7758 (daily ed. July 25, 1984); *see* Wang, *supra* note 155, at 1189-90 (discussing brief legislative history of § 20(d)).

202. *See, e.g.*, SEC v. Tome, 638 F. Supp. 596 (S.D.N.Y. 1986), *aff'd*, 833 F.2d 1086 (2d Cir. 1987), *cert. denied*, 486 U.S. 1015 (1988).

ties. The provision does not, however, determine whether options traders can sue defendants trading on nonpublic information in the underlying common stock. As derivative securities, options are affected by trading in the underlying corporate stock.[203] Whenever an inside trader has defrauded purchasers or sellers, the options traders have also been defrauded because they have been deprived of the material information used by the inside trader.[204]

Laventhall dealt with a suit by an options trader against defendants trading in common stock. The court rejected the plaintiffs' claim because there was no "transactional nexus" between the parties, because they traded in different markets.[205] Section 20(d) does not, on its face, alter the conclusion in *Laventhall*, and *Chiarella*'s fiduciary duty principle continues to govern cases when options traders sue defendants transacting in the underlying security.

Suits by options traders against insiders trading in common stock, and vice-versa, must be based on rule 10b-5, not section 20(d). Section 20(d) establishes liability for violations of rule 10b-5 in transactions with purchasers and sellers of "that security," that is, the derivative security.[206] The statutory private right of

203. *See* Deutschman v. Beneficial Corp., 841 F.2d 502, 504 (3d. Cir. 1988), *cert. denied*, 109 S.Ct. 3176 (1989). ("The market price for options is directly responsive, therefore, to changes in the market price of the underlying stock, and to information affecting that price."). Increased demand in the equity market can lead directly to increased demand in the derivative market and vice-versa. For example, the insider's purchase of common stock may increase demand for the stock by causing brokers to purchase additional shares to replenish their inventory or to cover a short position. Some market makers selling the shares may cover their position by purchasing call options for the underlying common stock. If there is a sufficient increase in demand for the stock, other firms may enter the market to follow the increase in the volume. The price of the stock and options may then increase because of greater demand. Similarly, if an insider purchases call options, firms writing the call options may cover their position by acquiring options from other firms or by purchasing the underlying common stock if the options are exercised. The interrelationship of the equity and derivative securities markets means that transactions on one market will affect trading on the security's related market.

204. *See* Crespi, *Private Rights of Action for Option Position Holders Under Section 20(d) of the Securities Exchange Act*, 16 SEC. REG. L.J. 21, 28 (1988) (reasonable to construe § 20(d) to confer on option holders a cause of action against insider trading in stock where option traders suffer injury).

205. Laventhall v. General Dynamics Corp., 704 F.2d 407, 412 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983).

206. Professor Wang notes that the language of § 20(d) is ambiguous, and "that security" may refer to the derivative securities listed in the provision, or to the underlying common stock. Wang, *supra* note 155, at 1188. The better interpretation, based on the legislative history of the section, is that Congress intended to give options traders a cause of action against insiders trading options comparable to the insider's liability for trading stock to persons trading in the equity market. *Id.* at 1190. Section 20(d) does not appear to provide a statutory basis for option traders to sue insiders trading in common stock.

action for options traders has created an exception to rule 10b-5's standing limitations, as interpreted by the Supreme Court in *Chiarella*, but has not overturned the fiduciary duty limitation on 10b-5 actions. Section 20(d) cannot be read as implicitly amending rule 10b-5 to permit claims by any person injured by insider trading, because ITSA was not meant to change the law of insider trading, including *Chiarella*.[207] Congressional encouragement of private claims under rule 10b-5 is not tantamount to eliminating *Chiarella*'s fiduciary duty requirement for insider trading actions.

If a residual effect of rule 10b-5 is to allow options traders to sue persons trading common stock, Section 20(d) is superfluous, because options traders would have standing to bring insider trading actions without the need for any additional statutory basis. Commentators argue that both the economic similarity between options and stock and the fact that options help keep the market in the underlying stock liquid justify granting options traders standing under rule 10b-5 to sue insiders trading in the common stock.[208] Economic identity does not, however, affect whether the inside trader owes a fiduciary duty to the options-trading plaintiff. Congress fully recognized that Section 20(d) eliminated a loophole in rule 10b-5 caused by *Chiarella*, but nonetheless did not overturn that decision.[209]

C. *Debt Securities: Overlooked but Not Unprotected*

Corporations raise capital not only by issuing stock, but also by borrowing. Companies now avoid bank loans by directly tapping the national and international securities markets to raise funds through public and private debt offerings.[210] Large amounts of

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207. *See* HOUSE ITSA REPORT, *supra* note 201, at 13-14 (House committee rejected proposal to enact a definition of "insider trading" because law in that area was sufficiently well developed).

208. *See* Note, *Option Investors*, *supra* note 173, at 1969 (options decrease stock volatility, increase market liquidity, and promote trading; fairness "dictates that the corporation and its insiders owe option investors some duty in return for these benefits."); Note, *Option Trader Standing*, *supra* note 173, at 639-40 (disclosure of information influences both stock and options prices, and "lack of potential privity between insiders trading in stock and option traders is irrelevant in an open market trading situation.").

209. *See* CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato) (Section 20(d) makes clear that "it is not possible to insulate oneself from the prohibition of insider trading by restricting activity to securities that are derivative of the securities to which the material nonpublic information relates.").

210. *See* ECONOMIC DIVISION OF THE CONGRESSIONAL RESEARCH SERVICE 100TH CONG., 1ST SESS., LEVERAGED BUYOUTS AND THE POT OF GOLD: TRENDS, PUBLIC POLICY, AND CASE STUDIES 6 (Comm. Print 1987) (leveraged buyout market expanded as investment banks provided corporations direct access to public debt markets) [hereinafter LEVERAGED BUYOUTS REPORT].

this debt have been used to shrink or eliminate the corporate equity base through repurchases of stock.

The growth of corporate debt has expanded the securities markets for commercial paper, which represent short-term borrowings, and bonds, which represent long-term obligations. Much of the debt market's expansion in the 1980s was fueled by the explosive development and creative uses of "junk" bonds to finance corporate transactions ranging from recapitalizations to leveraged buyouts. Rule 10b-5 prohibits fraud in transactions involving "securities," but until recently the possibility of insider trading in corporate bonds was minimal. The development of the bond market and the use of debt as an important tool of corporate finance creates the strong possibility that some may seek to profit from transactions in corporate debt instruments by the use of material nonpublic information.

Traditional corporate law principles recognized a corporation's fiduciary duty to its equity owners. Creditors, including bond owners, were governed by the contractual terms of their agreement, the trust indenture, and directors' duties to creditors were limited.[211] The recent development of new, innovative securities has created investment vehicles that feature characteristics of both stocks and bonds. As one author has noted:

> Distinctions between debt and equity securities are increasingly blurred in today's capital markets. High-yield, low-rated bonds look like debt but trade like equities. Many preferred stocks look more like debt than equity. Hybrid securities, such as convertibles, combine debt and equity features.[212]

The trend in corporate transactions to make extensive use of debt securities to finance deals has increased volatility in the bond market. Especially in leveraged buy-outs, in which the corporation assumes an enormous debt load in comparison to the owners' equity investment, blue chip corporate bonds have been subject to large price swings.[213]

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211. *See* FLETCHER CYC. CORP. § 849 (perm. ed. 1986) (directors not wholly without duty to creditors, but there is a conflict as to the scope of the duty).

212. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 417 (1986) (citations omitted).

213. *See* Herman, *Corporate Bonds Remain Tainted from Buy-Outs*, Wall St. J., Oct. 12, 1989, at C1, col. 1 (decline in value and effect on corporate bond prices from massive $25 billion RJR Nabisco leveraged buyout continues one year after transaction); Winkler & White, *Shock Still Clouds Blue-Chip Corporate Bond Market*, Wall St. J., Mar. 22, 1989, at C1, col. 1 (bond market remains shaken by RJR Nabisco leveraged buyout as investors continue to shun corporate debt market and demand greater protection from extraordinary transactions in debt covenants).

The potential for trading on inside information in corporate bonds has increased because the market value of corporate bonds is sensitive to transactions involving additional debt.[214] The value of junk bonds can plumet when the company experiences cash flow problems endangering its ability to meet current interest obligations. The insider trading scenario would be different for debt securities than for transactions in stock or options, however, because the insider anticipates a decline in the price of bonds already outstanding. The trader would seek to avoid a loss from the expected decline in the bond price by selling any holdings, or to profit by selling short the debt securities, rather than acquiring the issuer's stock or options.

Whether bondholders have standing to sue for violations of rule 10b-5 depends on how broadly courts construe the duty owed to the corporation's creditors.[215] In *Pittsburgh Terminal Corp. v. Baltimore & Ohio Railroad*,[216] the Third Circuit held that corporate management owed owners of convertible bonds a fiduciary duty because "we are here dealing with securities having an equity option feature."[217] In *Broad v. Rockwell International Corp.*,[218] the Fifth Circuit held that a controlling stockholder owed a fiduciary duty to creditors, including convertible bondholders, but the duty was not breached if the stockholder complied with the terms of the trust indenture.[219] In *Harff v. Kerkorian*,[220] however, the Delaware Supreme Court held that directors did not owe a fiduciary duty to bondholders, including convertible bondholders.[221] If bondholders are not owed a fiduciary duty by the corporation and its insiders, transactions in debt securities while in possession of material nonpublic information would not be a violation of rule 10b-5 under *Chiarella*.

214. *See* LEVERAGED BUYOUT REPORT, *supra* note 210, at 58 (as new debt is added to a company as a result of a transaction, the value of the old debt declines).

215. McDaniel argue that courts should recognize a fiduciary duty to bondholders owed by the corporation and its directors, especially in extraordinary corporate transactions when stockholders reap the benefits of the transaction while the corporation increases its debt. McDaniel, *supra* note 212, at 449-50. If bondholders are not owed a fiduciary duty there will be a "large gap" in rule 10b-5. *Id.* at 294. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 266 (1988).

216. 680 F.2d 933 (3d Cir.) *cert. denied*, 459 U.S. 1056 (1982).

217. *Id.* at 941.

218. 614 F.2d 418, 430-31 (5th Cir. 1980), *aff'd*, 642 F.2d 929, 958, *cert. denied*, 454 U.S. 965 (1981).

219. *Id.* at 438-39.

220. 347 A.2d 133 (Del. 1975).

221. *Id.* at 134.

The United States Supreme Court held in *Pepper v. Litton*,[222] that "fiduciary standards of conduct" govern a majority stockholder's dealings with "the corporation, its stockholders, and its creditors."[223] Whether courts might have relied on *Pepper v. Litton* to bypass any limitations imposed by *Chiarella* on bondholders in 10b-5 cases was rendered moot by the enactment of ITSFEA's contemporaneous trader provision. The new Section 20A permits claims for trading while in possession of material nonpublic information by persons purchasing or selling "securities of the same class,"[224] and the Exchange Act's definition of "'security' means any note, . . . bond, debenture . . . ."[225]

Unlike options traders, who do not have a fiduciary relationship with the corporation, purchasers and sellers of convertible debentures may argue that an insider trading in the common stock that is the class of security related to their conversion option has breached a fiduciary duty to the convertible bondholders by trading on nonpublic information.[226] The conversion value of convertible debentures is based, in part, on the price of the underlying equity security. As the Third Circuit noted in *Pittsburgh Terminal Corp. v. Baltimore and Maryland Railroad Co.*,[227] convertible debentures have an equity feature that imparts the fiduciary duty owed to other equity owners of the corporation. In order to bring a rule 10b-5 claim against an insider trading in common stock, however, convertible debenture holders would have to overcome *Laventhall*'s "transactional nexus" analysis, which requires that plaintiffs transact in the same market as the defendant.

Convertible securities present a troublesome question under rule 10b-5 because the security's value is affected, at least partially, by transactions in the equity security into which it can be converted, yet private parties cannot bring claims against insiders trading in the stock under *Laventhall*. Convertible debentures bear some similarity to options, in that the value of both is derivative of a

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222. 308 U.S. 295 (1939).

223. *Id.* at 311.

224. 15 U.S.C. § 78t-1(a) (1988).

225. *Id.* § 78c(10).

226. Convertible corporate securities are usually either preferred stocks or bonds that are exchangeable at the holder's option for a set number of another form of securities, usually common stock. *See* J. DOWNES & J. GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 78 (2d ed. 1987). A convertible debenture's value consists of the return on the debt investment and the potential value of the equity conversion. *See* J. WALMSLEY, THE NEW FINANCIAL INSTRUMENTS: AN INVESTOR'S GUIDE 65 (1988). Convertibles will usually have a fixed conversion price for exchanging to the common stock of the issuer.

227. 680 F.2d 933, 941 (3d Cir.), *cert. denied*, 459 U.S. 1056 (1982).

related security, but the convertible debenture does not receive the same protection that options received under Section 20(d), and Section 20A cannot be stretched to cover trading outside the class of securities in which the insider traded. Congress, therefore, left a gap in the right it granted to private parties to bring claims against insider traders by ignoring convertible securities. That gap should be filled by granting holders of these securities a right of action.

D. Corporate Claims Under Rule 10b-5 for Insider Trading: The Legacy of Chiarella

The one party overlooked regularly in rule 10b-5 actions involving insider trading is the corporation whose information was used to reap a benefit in the securities market. Until recently, defrauded corporations did not raise their voices in federal court to protest the exploitation of their property. Anheuser-Busch Companies, Inc. finally broke the silence in 1986 by suing inside traders and tippees who used information about an impending acquisition when purchasing shares of the target corporation. The corporate plaintiff in *Anheuser-Busch Cos., Inc. v. Thayer*[228] alleged that, as a result of the insider trading, the target's stock price was increased artificially, increasing the cost of the transaction by eighty million dollars. Anheuser-Busch premised its rule 10b-5 claim on the misappropriation theory, and the court permitted it to proceed to trial.[229]

In *FMC Corp. v. Boesky*,[230] FMC Corporation sued perhaps the most famous inside trader, Ivan Boesky, over corporate information leaked to Boesky concerning a proposed recapitalization that included a $70 per share cash payment to shareholders. In the four days prior to the initial announcement of the recapitalization, Boesky acquired 95,300 shares, approximately thirteen percent of the total volume during that period, and the stock price rose from $71.25 to approximately $85.[231] Two months later, while FMC considered increasing the cash payment, Boesky and others with knowledge of FMC's deliberations acquired 1,922,000 more shares.[232]

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228. Anheuser-Busch Cos. v. Thayer, No. CA3-85-0794-R (N.D. Tex. filed Apr. 26, 1986).

229. *See* Anheuser-Busch Cos. v. Thayer, No. CA3-85-0794-R (N.D. Tex. Aug. 19, 1986) (Order Denying Summary Judgment), *discussed in* Goelzer and Bereuffy, *Insider Trading: The Search for a Definition*, 39 ALA. L. REV. 491, 515 n.143 (1988).

230. 673 F. Supp. 242 (N.D. Ill. 1987) *rev'd*, 852 F.2d 981 (7th Cir. 1988).

231. *Id.* at 244.

232. *Id.*

FMC ultimately raised the cash payment to $80 per share, increasing the cost of the recapitalization by $220,000,000 and Boesky and other insiders realized a profit in excess of $20,000,000.[233]

The district court dismissed the rule 10b-5 claim, holding that FMC did not have standing under Article III of the Constitution because it had not been injured by the defendants.[234] The court viewed the recapitalization as a distribution of assets from the corporation to its shareholders and held that there was not a purchase or sale of securities in the transaction.[235] Because the shareholders held the same assets as before the transaction, the court found that FMC was not injured by Boesky's fraudulent trading and dismissed the complaint.[236]

The Seventh Circuit reversed, holding that the plaintiff corporation had standing under Article III to bring its claim in federal court.[237] The circuit court emphasized that it was not determining whether FMC had standing under the securities laws,[238] but only that Boesky's "misappropriation constitutes a distinct and palpable injury that is legally cognizable under Article III's case or controversy requirement."[239] The opinion posited that, although FMC was not deprived of the use of the information, it "was denied the right to use exclusively its confidential information. And that is an injury."[240]

The district and circuit courts' analyses bear little relation to the proper analysis of an insider trading action under rule 10b-5. The district court found that FMC's claim did not meet the Article III case or controversy requirement for constitutional standing, a wholly unnecessary conclusion that only obfuscates the 10b-5 analysis. Because FMC did not sell its own securities in the recapitalization, it failed to satisfy the *Blue Chip* purchase-or-sale

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233. *Id.*

234. *Id.* at 251.

235. *Id.* at 250. The court found that "[A]fter the recapitalization, the shareholders of FMC, while remaining the same, held different equity interests than before. Thus, the transaction effected a shift of part of the equity from public shareholders to management shareholders." *Id.*

236. *Id.* at 251.

237. 852 F.2d 981, 987 (7th Cir. 1988).

238. *Id.* at 989 ("[T]hat FMC was not injured in a way covered by certain securities laws does not mean it was not injured *at all.*") (emphasis in original).

239. *Id.* at 989-90.

240. *Id.* at 991. Although the majority stated that it was not reaching the issue of whether FMC stated a cognizable claim under the federal securities laws, *id.* at 994, Judge Mannion dissented, stating that "FMC may be irritated, but it has not been injured." *Id.* at 997 (Mannion, J., dissenting).

requirement.[241] Instead of dismissing the case on that ground, however, the district court unnecessarily used the constitutional standing barrier to find that FMC was not injured in the transaction.

Unfortunately, the circuit court compounded the problem by failing to reject the district court's constitutional injury analysis, instead citing *Carpenter v. United States*[242] for the proposition that the misappropriation of valuable, confidential business information constitutes an injury.[243] Without analyzing whether FMC could even bring its claim under the securities laws, the Seventh Circuit adopted *Carpenter*'s misappropriation theory of liability to find an injury for constitutional purposes. Regardless of whether the circuit court's constitutional analysis was correct, FMC could not bring a rule 10b-5 action because, as noted above, it did not meet the *Blue Chip* standing requirement. The opinions in *FMC Corp.* unnecessarily reached a constitutional issue while ignoring the proper standing analysis for rule 10b-5.

Any corporation whose information is used for insider trading faces substantial hurdles in pursuing a private rule 10b-5 action. First, if the transaction did not involve the purchase or sale of the corporation's securities prior to the public announcement, *Blue Chip* prohibits the corporation from suing. This may occur in recapitalizations similar to the one in *FMC Corp.*, involving an extraordinary dividend or security swaps that do not involve a purchase or sale. Another transaction that does not meet the *Blue Chip* standard is when the offeror ultimately does not acquire any shares of the target corporation because the transaction cannot be completed. This may occur if the offeror cannot secure financing or if a competing offeror succeeds. By never purchasing the target's stock, the unsuccessful tender offeror does not satisfy the *Blue Chip* standard even though information about its plans may have been the basis of the inside trader's purchases.

Second, even if the corporate plaintiff overcomes the *Blue Chip* requirement, it will usually be on the same side of the transaction as the inside trading defendants, because the defendants will pursue the same course of action as the corporation to capitalize on the market's lack of knowledge prior to an announcement. This situation is exemplified by a hostile tender offer, when the target corporation does not have information about the offer prior to the announcement and the information has been misappropriated

241. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).
242. 484 U.S. 19 (1987).
243. *FMC Corp.*, 852 F.2d. at 990.

from the offeror. The corporation whose information is misappropriated will not be a "contemporaneous" trader under either Section 20A or the case law because it could not have traded with the defendant, but only with defrauded purchasers or sellers. Moreover, in transactions in which a corporation acquires shares of a publicly traded company, the target company will not have a fiduciary relationship with the inside trader who uses the offeror's information.[244] The acquiring corporation will usually have the necessary fiduciary relationship with the trader, or the information will have been misappropriated from that corporation, but the insider will not have traded in the acquiror's securities, only the target's. Therefore, *Chiarella*'s requirement that the defendant owe a duty of disclosure to the corporation in whose securities the insider traded, and to its shareholders, persists as a substantial limitation on standing for corporations bringing private rule 10b-5 actions.

Third, the corporation may not be able to prove any injury from the insider trading. As the district court analysis in *FMC Corp.* demonstrates, in transactions that provide shareholders with a portion of the corporate assets as an extraordinary distribution, the only "injury" is the conversion of more assets to cash for use by the corporation's owners; the corporation has not "lost" anything. Even in tender offers, whether made by a hostile bidder or friendly suitor, the defendant's transactions may be small compared to the total volume of shares traded during the period. Increases in the target's stock price may be attributable to rumors concerning the target, foothold purchases by potential bidders prior to an announcement, or even a general rise in the market, rather than to trading by persons in possession of nonpublic information.[245]

A corollary issue is whether an inside trader should be liable for all damages a corporation may sustain from increases in the stock price, especially when the insider's profits are minuscule compared to the plaintiff's alleged loss.[246] Even assuming the increased costs of the transaction could be traced to the defendant's

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244. *See* Walton v. Morgan Stanley & Co., 623 F.2d 796, 799 (2d Cir. 1980) (advisor to potential offeror does not have fiduciary duty to shareholders of target corporation).

245. *See* A STUDY BY THE OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, STOCK TRADING BEFORE THE ANNOUNCEMENT OF TENDER OFFERS: INSIDER TRADING OR MARKET ANTICIPATION? (1987) (reviewing data from 172 tender offers between 1981 and 1985 to determine why prices rise prior to announcement of transaction).

246. Even in *FMC*, when the trading defendants made over $20 million, the corporate plaintiff claimed a loss attributable to trading prior to the announcement of $220 million. *FMC Corp.*, 673 F. Supp. at 244.

trading, imposing liability for all costs related to an increase in the market price would be "Draconian."[247]

The original version of ITSFEA provided a private right of action to any person, other than contemporaneous traders, injured by trading in material nonpublic information to recover any damages caused by the violation.[248] The House Energy and Commerce Committee deleted the provision prior to sending the bill to the floor to "avoid creating an express cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of actions which have been implied by the court in this area."[249] Although the House Committee eliminated this provision, the House ITSFEA Report reviewed the *Anheuser-Busch Cos.* case and stated that the Committee "expressly recognizes the implied right of action under the securities laws for cases including but not limited to the situations such as that noted above in the Anheuser-Busch case."[250]

Congressional recognition of the viability of the *Anheuser-Busch Cos.* suit, however, does not eliminate the limitations imposed on rule 10b-5 claims in *Blue Chip* and *Chiarella.* Congress did not overrule the Supreme Court precedents interpreting rule 10b-5, and it is extremely unlikely that a passage in a House Committee

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247. The flip side of the damages issue is whether corporate bidders should be protected from insider trading by the federal securities laws, which are primarily designed to protect investors in the public markets through the disclosure and antifraud provisions. *See* Seligman, *supra* note 17, at 1103-15 (describing policies of securities acts). An amendment to the securities laws has been proposed to create a private cause of action on behalf of corporations whose nonpublic information has been used in trading, similar to the § 16(b) short-swing profits claim that can be made on behalf of the issuer. *See* Karjala, *Statutory Regulation of Insider Trading in Impersonal Markets*, 1982 DUKE L.J. 627, 641 (1982).

248. The original bill provided:

> Any person (other than a person entitled to recovery solely under paragraph (1) of this subsection [contemporaneous traders]) injured by a violation described in such paragraph in connection with such person's purchase or sale of securities may bring an action in any court of competent jurisdiction to seek recovery of any damages caused by reason of such violation, or for appropriate equitable relief, or both.

Insider Trading: Hearings Before the Subcomm. on Telecommunications and Finance of the Comm. on Energy and Commerce, 100th Cong., 2d Sess. 14 (1989). The SEC's proposed legislation contained a substantively identical provision. *See SEC Legislative Proposal*, *supra* note 7, at 1818.

249. HOUSE ITSFEA REPORT, *supra* note 150, at 27. The Report's statement concerning the reason for dropping the noncontemporaneous trader provision, which would have allowed corporations whose information was used for insider trading to recover damages, appears to be disingenuous because the section was so controversial that its inclusion in the bill threatened passage of ITSFEA. *See* Kaswell, *An Insider's View*, *supra* note 28, at 168 (discussing reasons for deleting provision in committee).

250. HOUSE ITSFEA REPORT, *supra* note 150, at 28.

Report can validate a cause of action that Congress refused to enact and that does not otherwise meet the standing requirements created by the courts.

Corporate plaintiffs that cannot bring claims under Section 20A or Section 20(d), which substantially relax the fiduciary duty principle, must meet the traditional rule 10b-5 requirements and prove that they were purchasers or sellers of the securities, that their transactions were contemporaneous with the defendant's, and that the fraud involved the breach of a duty of trust and confidence owed by the defendant to the corporate issuer and its shareholders. The irony of rule 10b-5 insider trading litigation is that those parties who can show a breach of the fiduciary duty by an employee or other "temporary" insider, and who have been directly defrauded by the defendant, usually are corporations and their investment advisers. These parties generally will not have traded in the securities during the same period as the defendant and, therefore, do not have standing to sue.

If Congress supports an expansive approach to corporate rule 10b-5 claims and is serious about encouraging suits similar to *Anheuser-Busch Cos.*, it should specifically grant standing to these plaintiffs, instead of relying on the judiciary to hurdle the roadblocks erected by the Supreme Court in *Blue Chip* and *Chiarella*. If the fear of Draconian liability requires limiting a private cause of action, Congress should craft rules that will make a corporate plaintiff's damage award proportionate to the defendant's gain realized or loss avoided.

IV. CONCLUSION

The haphazard development of the standing requirements for private rule 10b-5 actions has left a confusing trail for plaintiffs and courts to follow. Congress has restricted *Chiarella's* applicability to private claims by contemporaneous traders who transact in the same class as the inside trader, in addition to granting options traders an express right of action. The fiduciary duty principle, however, remains viable for claims by options and convertible securities traders suing for transactions in the underlying common stock, despite the effect trading in the underlying security has on the value of derivative securities. That the confusion has spread to some courts is evident from the application of *Chiarella* to affirmative misrepresentation claims under rule 10b-5 by options traders. This is entirely inconsistent with the proper understanding of the duty to correct any misstatements or omissions owed by corporations and persons that publicly disseminate false information. Despite its enthusiasm for rule 10b-5 claims by private parties, Congress thus far has been unwilling to take the final step in crafting a coherent scheme to determine which parties have standing. Until Congress acts, private parties will continue to argue preliminary issues of standing rather than the substantive question of whether they were injured by the fraudulent use of nonpublic information in the trading of securities.