Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain

Insider trading, the term used to describe "the act of purchasing or selling securities while in possession of material, nonpublic information about an issuer or the trading market for an issuer's securities," has been denounced almost universally by the courts, the Securities and Exchange Commission (SEC) and the American business community. Notwithstanding strong legal, economic, and social debate over "what constitutes unfair advantage and what is fair reward for the diligent pursuit of the knowledge that aids investment decisions," public censure has developed largely from a strong belief that insider trading is unfair.

Some economists advocate insider trading, arguing that the use of inside information increases the market's pricing efficiency by indirectly supplying such information to the market. Most commentators, however,


2. Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement, 70 CALIF. L. REV. 1, 1 n.2 (1982); see also H. MANNE, INSIDER TRADING AND THE STOCK MARKET at v (1966) ("Probably no aspect of modern corporate life has been more roundly condemned than insider trading.").


4. Langevoort, supra note 2, at 2; see also INSIDER TRADING SANCTIONS ACT OF 1983, H.R. REP. NO. 355, 98th Cong., 1st Sess. 2-3 (1983), reprinted in 1984 U.S. CODE CONG. & AD. NEWS 2274, 2275-76; Wu, An Economist Looks at Section 16 of the Securities Exchange Act of 1934, 68 COLUM. L. REV. 260, 260 (1968) (arguing that insider trading restrictions have not been developed upon sound economic rationales, but in the "zealous pursuit of 'fairness' and 'protection of investors'" and that the public interest is "best served by regulation that takes into account both economic and equity considerations.").

5. See generally H. MANNE, supra note 2; Heller, Chiarella, SEC Rule 14e-3 and Dirks: "Fairness" versus Economic Theory, 37 BUS. LAW. 517, 555 (1982); Wu, supra note 4; Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031, 1073-75 (1977). But see Jennings, Book Review, 55 CALIF. L. REV. 1229 (1967) (critiquing Manne's thesis). Generally, these economists argue that restrictions on insider trading ignore the objective goals of allocative efficiency, H. MANNE, supra note 2, at 2-4, and that all investors will be better served by developing a system that causes stock prices to move gradually to their "true" value. Id. at 99-103.

Professor Manne also argues that insider trading provides incentives for insiders to cause the corporation to move toward activities that increase stock prices, thus benefiting shareholders. H. MANNE, supra note 2, at 131-45. This theory, however, does not justify the insider's use of confidential information to sell his interest when the market value of the stock has diminished. See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974).

483
ever, contend that considerations of fairness and investor confidence vastly outweigh any potential allocative benefits. Other economists argue that insider trading is a victimless crime, but this theory is also attacked on fairness principles. Both the SEC and the courts have relied on notions of fairness to investors to proscribe insider activity.

Despite the unequivocal stance taken by the SEC and the courts against insider trading, the use of inside information in securities transactions continues to rise. This is due in great part to the tremendous, virtually risk-free profit potential in trading on undisclosed information and the insufficiency of the remedies and resources currently available to the SEC to deter this activity.


"When we engage in economic analysis, we do not banish permanently the legal and moral aspects of the problem analyzed. . . . Even if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market . . . that satisfies such noneconomic goals as fairness, just rewards and integrity. See also Longstreth, Halting Insider Trading, N.Y. Times, Apr. 12, 1984, at A27, col. 3 ("The arguments in favor of insider trading are, in short, rubbish.")."

7. Many commentators have noted that a party engaging in securities transactions on an impersonal market exchange is not disadvantaged by the insider's purchases in the market. In transactions conducted on a public exchange, it is often impossible to match the insider's trades with those of the person on the opposite side of the transaction, and both parties have made independent decisions to buy or sell. See, e.g., Dooley, Enforcement of Insider Trading Restrictions, 66 VA. L. REV. 1, 33 (1980) (arguing that the losses of those who "lose" money in the market exactly offset the gains of those who "win," and, therefore, the losing traders are simply "incidental participants in [an activity] that would go on without them"). Even if the innocent trader would not have gained when the information became public, however, the person who would have purchased had the insider not been active in the market is robbed of his gain. Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5, 54 S. CAL. L. REV. 1217, 1234-38 (1981).

Insider trading harms other market participants as well:

 Corporations . . . may find it more expensive to raise capital if insiders are siphoning off secret profits through informational advantages. Specialists who write stock options have been bankrupted by honoring commitments to insiders. Finally, the markets themselves may suffer. Many believe that rampant insider trading would destroy public confidence in the securities markets, discouraging investors from using securities and, ultimately, impairing capital formation.

Longstreth, supra note 6, at A27, col. 3.

Regardless of whether insider trading is a victimless crime, the noninsider is "clearly at a disadvantage" when trading opposite the party with inside information. This in turn results in sagging investor confidence in the securities markets. 130 CONG. REC. S8912 (daily ed. June 29, 1984) (remarks of Sen. D'Amato on the Insider Trading Sanctions Act of 1984). The legislative history of the securities laws emphasizes congressional concern with promoting market integrity and investor confidence. See infra notes 87-91 and accompanying text.

8. SEC Memorandum, H.R. REP. No. 355, supra note 1, at 21, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 2293; see also Schotland, supra note 6, at 1438 ("['P']rotection of investors' is one of the two dominant goals of the [Securities Exchange Act of 1934], receiving the same prominence as . . . 'in the public interest.' ").

9. Illegal Insider Trading, supra note 3, at 1, col. 6; see also SEC Memorandum, H.R. REP. No. 355, supra note 1, at 21, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 2293; Dooley, supra note 7, at 5-7.
Recently, the Supreme Court has narrowed the scope of liability for insider trading. To be liable, the trader must have a fiduciary duty to disclose the inside information. Rigid application of the fiduciary duty principle, however, fails fully to prevent inside information abuses. The current problems facing the SEC and private litigants do not arise from traditional instances of insider trading, but rather from noninsiders trading on inside information acquired through their status in the market or by other unfair means. Prosecution of these outside parties is difficult because it is virtually impossible to establish a duty to disclose the information to the purchaser or seller. Therefore, the Supreme Court's fiduciary principle alone does not adequately enforce notions of fairness or deter the use of inside information in the marketplace.

The lower courts have resisted the Supreme Court's lead. Recognizing the limitations of the fiduciary principle, they have chosen "to continue to develop [the law] in accord with perceptions about fairness in the securities marketplace." The result has been inconsistent application of the fiduciary duty test, tortured analysis of common law fraud concepts, and a lack of guidance as to when market participants may trade on informational advantages.

This Comment argues that there is no sound reason to allow a party unfairly in possession of inside information or otherwise engaged in clearly wrongful activity to trade in the national securities markets. Federal regulation of insider trading is both inadequate and unclear.

11. SEC Memorandum, H.R. REP. No. 355, supra note 1, at 23-24, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 2295-96. As used in this Comment, traditional insiders include officers, directors, controlling shareholders, agents, and others in clearly fiduciary roles. Other parties who by their relationship with the corporation or its affiliates, competitors, etc., have gained access to inside information will be termed "outsiders." This latter category includes market professionals, independent contractors, business associates, and persons with a unique ability to affect the market in the corporation's shares.
12. See infra text accompanying notes 96-139.
13. Many commentators have noted that deterrence should be the primary goal of insider trading prohibitions, taking precedence over other goals such as rapid information disclosure, compensation of injured investors, and market integrity. See, e.g., Karjala, Statutory Regulation of Insider Trading in Impersonal Markets, 1982 DUKE L.J. 627; Ratner, Federal and State Roles in the Regulation of Insider Trading, 31 BUS. LAW. 947, 956 (1976).
14. Langevoort, supra note 2, at 53.
Nonetheless, because national interests pervade the securities markets, the federal securities laws are the proper statutes to police this behavior. Therefore, further legislation is needed to clarify the scope of insider trading liability and to provide for a consistent enforcement scheme between public and private complainants.

Part I of this Comment reviews the law governing insider trading as developed by the Supreme Court and administrative and legislative reactions to the Court's fiduciary principle limitation. Part II analyzes both the statutory scheme and its legislative history to conclude that the net cast by the Supreme Court is insufficiently broad to police trading on inside information. Part II also presents a number of examples in which application of the fiduciary principle is particularly inadequate. A broader duty of disclosure for insider trading is therefore proposed in Part III. This approach encompasses a new remedy against outsiders trading on inside information, as well as traditional insiders—private corporate recovery of damages based upon restitutio

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THE LAW OF INSIDER TRADING

The federal securities laws were enacted in order to prevent the abuses in securities distribution and trading that had been so prevalent prior to 1933. These abuses were perceived as directly contributing to the economic conditions of the time. The Securities Exchange Act of 1934, in particular, was enacted to regulate securities transactions by protecting both purchasers and sellers.

In general, the philosophy of the federal securities laws is to promote disclosure; therefore, fraud, deceit, and misrepresentation are particularly offensive to the statutory scheme. Section 10(b) of the Exchange Act broadly prohibits manipulative or deceitful practices detrimental to the interests of investors. Under this section, the SEC is

17. Given the deleterious effects such trading has on the confidence investors place in the markets, the federal government has a strong interest in policing the overall integrity of the markets through federal statutes. See Exchange Act § 2, 15 U.S.C. § 78b (1982) ([The] securities [markets] are affected with a national public interest which makes it necessary to provide for regulation . . ."). Moreover, state courts may not have the requisite "jurisdiction to cover multistate fraud and other schemes that are occurring throughout the country." Levine, Recent Developments in SEC Enforcement, 61 N.C.L. REV. 463, 464 (1983).
given wide latitude to protect both investors and the public interest by
developing enforcement procedures adaptable to changing illegal activ-
ity. Section 10(b) is not a self-executing statute, however. Therefore, in
1942, the SEC promulgated Rule 10b-5 specifically to address the
problems of insider trading, closely following the congressional lead
against fraudulent securities practices. In sweeping language, the rule
makes it unlawful for any person to use any fraudulent device in connection
with the purchase or sale of any security.

The legislative and administrative history of Section 10(b) and Rule
10b-5 is meager and affords courts little guidance. Furthermore, the
express language of both the statute and the rule omit any reference to
insider trading. Therefore, federal law under Rule 10b-5 is largely the
result of judicial and administrative decisions interpreting the rule as
equity dictates. While this development has produced a consistent

23. See W. PAINTER, FEDERAL REGULATION OF INSIDER TRADING 19 (1968); see also The
on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 21 (1934); S. REP. No. 792, 73d Cong., 2d
Sess. 18 (1934).


25. Rule 10b-5 was patterned after the Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a)
(1982). See Freeman, Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793,
922 (1967).

26. The rule states:
It shall be unlawful for any person, directly or indirectly,
by the use of any means or
instrumentality of interstate~ommerce . . .
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of a material fact or to omit to state a material fact
necessary in order to make the statements made, in the light of the circumstances
under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate
as a fraud or deceit upon any person,
in connection with the purchase or sale of any security.
(“These proscriptions . . . are broad and, by repeated use of the word ‘any,’ are obviously meant to
be inclusive.”).

27. See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462, 473 & n.13 (1977); Ernst & Ernst v.

prohibits insider trading, granting corporate recovery of short-swing profits gained by clearly defined
insiders. Liability under § 16(b) does not require proof that the insider had actual possession of the
inside information; rather, insider status implies possession. Section 16(b) is largely ineffective, how-
ever, because it is too narrowly drawn. L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION
609-12 (1983).

29. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 n.12 (1976); Diamond v. Oreamuno, 24
trading under Rule 10b-5 as developed by the federal courts); LANGEVOORT, supra note 2, at 3; see also
GONSON & BUTLER, IN WAKE OF 'DIRKS,' COURTS DEBATE DEFINITION OF 'INSIDER', Legal Times,
Generally, courts have chosen to construe the rule very broadly to "effectuate its remedial purposes" and
to reach new species of fraudulent behavior. SEC v. Capital Gains Research Bureau, Inc., 375 U.S.
180, 195 (1963); see also Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 235
(2d Cir. 1974).
approach to traditional acts of insider trading, the outer boundaries of the rule are largely in dispute.\textsuperscript{30}

A. Judicial Development

1. Early Development of Insider Trading

In the early part of this century, the common law imposed a fiduciary relationship upon corporate officers and directors with their corporations only; no duty regulated these insiders' activities with regard to the corporation's shareholders.\textsuperscript{31} Nonetheless, a number of state courts began to place insiders in quasi-trustee relationships with the shareholders with whom they were trading.\textsuperscript{32} Common law fraud doctrine had developed through cases involving face-to-face transactions, however, and was thus ineffective in establishing sufficient duties on insiders trading in impersonal securities markets.\textsuperscript{33}

Enactment of the Exchange Act and Rule 10b-5 provided much needed protection for defrauded investors. Under the rule, the courts and the SEC eroded the common law privity\textsuperscript{34} and reliance requirements,\textsuperscript{35} and implied a private right of action.\textsuperscript{36} Furthermore, interpretations of Rule 10b-5 imposed a higher disclosure standard on insiders


\textsuperscript{32} As originally developed, liability for corporate insiders trading on inside information was nonexistent absent affirmative misrepresentations. W. KEETON, D. DOBBS, R. KEETON & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 106, at 737-38 (5th ed. 1984). This notion proved to be inadequate, however, particularly when applied to impersonal market transactions. In most cases the insider simply fails to disclose, rather than affirmatively misrepresent, his special knowledge. Therefore, in a series of cases decided prior to the enactment of the federal securities laws, the courts extended the general rule and imposed liability where there were "special facts" giving rise to a fiduciary duty to disclose before trading. See, e.g., Strong v. Repide, 213 U.S. 419 (1909); see also Oliver v. Oliver, 118 Ga. 362, 367-68, 45 S.E. 232, 234 (1903); Stewart v. Harris, 69 Kan. 498, 508, 77 P. 277, 281 (1904). Under this theory, the insider may trade with shareholders but, if he is aware of events which might affect the price of the securities, his relationship of trust binds him to inform the shareholder. Oliver, 118 Ga. at 368, 45 S.E. at 234; Stewart, 69 Kan. at 508, 77 P. at 281.


\textsuperscript{34} The phrase "in connection with the purchase or sale" apparently does away with a privity requirement under Rule 10b-5. Note, The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors, 59 YALE L.J. 1120, 1131 (1950); see also Superintendent of Ins. v. Banker's Life & Casualty Co., 404 U.S. 6 (1971) (following the same line of reasoning).

\textsuperscript{35} See Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) ("[P]ositive proof of reliance is not a prerequisite to recovery.").

than that required at common law: an affirmative duty to disclose based upon the fiduciary's duty of loyalty to his beneficiary.

In In re Cady, Roberts & Co., for example, the SEC ruled that "the inherent unfairness involved where a party takes advantage of [information intended to be available for a corporate purpose only] knowing it is unavailable to those with whom he is dealing" is sufficient to impose a duty to disclose. The federal courts adopted this fairness standard and set forth a disclose or abstain rule in SEC v. Texas Gulf Sulphur Co. This decision further eroded the common law model in favor of a fairness-oriented disclosure rule:

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

In this way, the law could satisfy the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information." The Second Circuit further expanded the duty to disclose in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. to include those parties (tippees) who trade based upon "tips" of confidential information from insiders (tippers). The tippee's obligation arises from his role as "a participant after the fact in the tipping [insider's] breach of fiduciary duty," and thus he is "subject to the same duties as the traditional

Huddleston, 103 S. Ct. 683, 687 (1983) ("The existence of [a Rule 10b-5] implied remedy is simply beyond peradventure.").

37. Note, supra note 34, at 1122.

38. See, e.g., Chiarella v. United States, 445 U.S. 222, 230 (1980); Langevoort, supra note 2, at 5. Although a direct fiduciary relationship extends only to current shareholders, the courts often have stretched fiduciary principles under Rule 10b-5 to include persons about to buy securities from the insider. See, e.g., Chiarella, 445 U.S. at 227 n.8; In re Cady, Roberts & Co. v. SEC, 40 S.E.C. 910, 914 n.23 (1960).


40. Id. at 912; see also Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951), aff'd, 235 F.2d 309 (3rd Cir. 1956).

41. 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971). Recognizing that insiders are often privy to information which if disclosed may be harmful to the corporation, the affirmative duty developed as one to either disclose the confidential information or abstain from trading, rather than as an absolute duty to disclose upon knowledge of inside events. Strong v. Repide, 213 U.S. 419, 430-31 (1909); Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977). Throughout this Comment the choice (or, more often, obligation) to abstain from trading absent disclosure generally is subsumed within the notion "duty to disclose."

42. Texas Gulf Sulphur, 401 F.2d at 848.

43. Id.

44. 495 F.2d 228 (2d Cir. 1974).


46. SUBCOMMITTEES OF THE AMERICAN BAR ASSOCIATION SECTION OF CORPORATION,
insider by virtue of his special access to inside information.”

The lower courts and the SEC have thus given Rule 10b-5 wide application, relying on the “inherent unfairness” theory stated in Cady, Roberts to grant all investors equal access to information in the marketplace. Until the mid-1970's the Supreme Court also broadly interpreted Rule 10b-5 in order to reach new types of wrongful activity. However, in 1975, the Court began to restrict the scope of the rule, placing greater emphasis upon misrepresentation, fraud, and deceit as the central bases for a violation. These opinions demonstrate the Supreme Court’s desire to limit “the growth of private actions, [prevent] vexatious litigation, and [draw] a line between internal corporate mismanagement and securities fraud.” This trend has had a significant impact on the scope of insider trading liability.

2. Supreme Court Development of Insider Trading: The Fiduciary Principle

In 1980, the Supreme Court squarely confronted the substantive law of insider trading under Rule 10b-5 for the first time. Presented with an outsider trading on inside information, the Court had an excellent opportunity to set the parameters of liability under Rule 10b-5. The Court chose, however, to limit the scope of the rule.

In Chiarella v. United States, the Supreme Court held that absent a relationship of trust or confidence giving rise to a fiduciary duty, an outsider trading on inside information cannot be held liable under Rule 10b-5. Chiarella involved the trading activities of a financial printing company employee. The company prepared solicitation materials for...
INSIDER TRADING

offeror companies engaged in takeover acquisitions and merger proposals. Chiarella had access to these documents. Although the printing company removed the names of both the acquiring and target companies until the final printing, Chiarella was able to determine the identity of the target companies and proceeded to buy target company stock. When the takeover bids were announced, the price of the target company stock rose sharply, and Chiarella was able to reap a profit.

As an employee of an agent of the acquiring corporation, Chiarella was not a traditional insider. Nevertheless, his special access to confidential information gave him knowledge of important developments before they were known to the general public. The Department of Justice brought a criminal action against Chiarella for violations of Section 10(b) and Rule 10b-5. The Supreme Court held that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic . . . information."53 Rather, "the duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"54 Finding that the defendant was not in a relationship of trust or confidence with the sellers of the target companies' securities, the Court held that he had no duty to disclose.55

In dissent, Chief Justice Burger argued for liability based upon a theory of misappropriation. Burger stated that any "person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."56 The Chief Justice found that the misappropriation theory had strong support from tort law, the legislative history of Section 10(b), and the SEC's Cady, Roberts decision. Such a theory, he stated, would prevent undue advantages and preferences among investors, thereby assuring fair and equitable securities markets.57 Justice Blackmun, also dissenting, adopted a broader theory of liability: persons having special access to inside information should have

53. Id. at 235.
54. Id. at 228 (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). While the language of the Court's opinion appears exclusive, § 551 of the Restatement includes situations other than a relationship between the parties of trust and confidence. See, e.g., RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976), imposing a duty where the other party "would reasonably expect a disclosure of those facts [basic to the transaction]." The Restatement also states, however, that "[i]t is not within the scope of this Restatement to state the rules that determine the duty of disclosure which under the law of business associations the directors of a company owe its shareholders." Id. comment e.
56. Id. at 240 (Burger, C.J., dissenting) (emphasis added).
57. Id. at 240-41 (Burger, C.J., dissenting); see also SEC v. Musella, 578 F. Supp. 425, 438 (S.D.N.Y. 1984) ("[T]he . . . 'misappropriation' theory of Rule 10b-5 liability . . . [gives] legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair, and that distinctions premised on the source of the information undermine the prophylactic intent of the securities laws.").
a strict duty to disclose or abstain, at least where others could not lawfully overcome this informational advantage regardless of diligence or resources.\(^{58}\)

In *Dirks v. SEC*,\(^{59}\) the Supreme Court again addressed the Rule 10b-5 duty to disclose. Dirks, an investment adviser, had received confidential information from concerned employees that an investment company was engaged in a vast scheme of fraudulent behavior. Before this information was disclosed to the general public, Dirks conveyed the news to several of his clients who had substantial holdings in the corporation. In order to avoid the huge potential loss in value that would occur once the scandal became public, the clients immediately sold substantial blocks of the investment company stock.

In holding that Dirks had not violated the securities laws by tipping the information to his clients, the Supreme Court found that he had no pre-existing duty to the investment company's shareholders and had taken no actions that would induce the shareholders' trust and confidence.\(^{60}\) The Court also refused to impose a derivative fiduciary duty upon Dirks as a tippee because the actual insiders were motivated by a desire to expose internal fraud rather than by any personal benefit to themselves.\(^{61}\) Thus, they had breached no fiduciary duty in disclosing the information. Finally, the court found that the tippee who trades upon inside information is liable only if he knows or should have known that his tipper acted wrongfully.\(^{62}\)

After *Dirks*, then, the insider's misconduct, rather than the trader's mere possession of inside information, is the basis for liability under Rule 10b-5.\(^{63}\) The tippee's duty to disclose or abstain is derivative of the insider's duty. Nonetheless, although the decision reinforces the Supreme Court's adherence to the fiduciary principle, it neither approves nor disapproves other theories of liability. The Court reinforced the broader *Cady, Roberts* view of the duty to disclose, creating a fiduciary

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60. Id. at 3266-67.

61. "Dirks therefore could not have 'a participant after the fact in [an] insider's breach of a fiduciary duty.'" Id. at 3268 (quoting *Chiarella*, 445 U.S. at 230 n.12.).

62. Id. at 3264 n.19; see also State Teachers Retirement Bd. v. Fluor Corp., 500 F. Supp. 278, 300 (S.D.N.Y. 1980) (tippee must know or should have known of the tipper's breach of his fiduciary duty, including the tipper's intent to personally benefit), modified on other grounds, 654 F.2d 843 (2d Cir. 1981).

63. "[I]t is thus necessary to determine whether the insiders 'tip' constituted a breach of the insider's fiduciary duty." *Dirks*, 103 S. Ct. at 3265; see also *In re Investors Management Co.*, 44 S.E.C. 633, 648 (1971) ("It is important in this type of case to focus on policing insiders and what they do . . . rather than on policing information *per se* and its possession . . . "). (Smith, Comm'r, concurring).
relationship when the trading party is given information intended solely for corporate purposes. Furthermore, Dirks raises no obstacle to use of the misappropriation theory proposed by the Chief Justice in Chiarella.

B. Responses to Insider Trading

In July 1984, President Reagan signed legislation designed to curb the abuse of inside information by sharply increasing the penalties associated with its illegal use. The Insider Trading Sanctions Act of 1984 amends Section 21(d) of the Exchange Act to give the SEC authority to seek a civil money penalty of up to three times the profit gained (or loss avoided) by an inside trader.

The effects of the Insider Trading Sanctions Act of 1984 are limited. The Act only improves the enforcement capabilities of the SEC; increased relief for private claimants is unavailable. Additionally, the treble damages penalty only applies to those who actually trade and their tippers, if any. Although the SEC foresees that it will not always seek the maximum penalty, it supports the increased sanctions in order to

64. Dirks, 103 S. Ct. at 3261 n.14 (see infra text accompanying notes 97-102); see also id. at 3264 ("[T]he tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly. And for Rule 10b-5 purposes, the insider's disclosure is improper only where it would violate his Cady, Roberts duty.") (emphasis in original) (citations omitted).


67. In addition, § 32 of the Exchange Act, 15 U.S.C. 78ff (1982), was amended to increase criminal fines for certain violations (including securities fraud and manipulation) from $10,000 to $100,000, and § 15(c)(4), 15 U.S.C. 78o(e)(4) (1982), was amended to give the SEC authority to bring administrative proceedings against persons violating § 14, 15 U.S.C. § 78n (1982). The fines assessed for violation of the securities laws had not been increased since enactment of the Exchange Act, even though inflation had largely eroded their deterrent effect.


68. Thus, although a nontrading party is subject to increased sanctions if he knowingly communicates confidential information to someone who trades, nontipping aiders and abettors cannot be held vicariously liable for treble damages. They may still be liable under existing law, however. Furthermore, the treble damages provision is unavailable under a theory of respondeat superior and, therefore, employers and controlling persons are not subject to increased sanctions solely for violations of their employees or controlled persons. Insider Trading Sanctions Act of 1984 § 2 (amending Exchange Act § 21(d) and adding § 21(d)(2)(B)), reprinted in 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 1264, 1264-65; see also Fischel, Secondary Liability Under Section 10(b) of the Securities Act of 1934, 69 CALIF. L. REV. 80, 83-85 (1981).
“create a formidable deterrent to illegal insider trading by persons who might now be tempted to seize the opportunity for large illegal profits.”

Additionally, the Insider Trading Sanctions Act of 1984 does nothing to clarify the substantive law of insider trading. Rather, it depends on existing case law to define the scope of the disclosure duty for insider trading. During legislative hearings on the Act, one of the most hotly contested issues was whether or not to include specific language defining the scope of the violation. Proponents of a statutory definition argued that the case-by-case approach was inappropriate for a treble damages penalty because it did not provide “clear boundaries of acceptable conduct.” Those opposed to the definition reported that the unclear parameters of the law in fact aid deterrence—that “unscrupulous traders would skirt around any definition constructed.”

Nevertheless, insider trading law is insufficiently developed. The current fraud-based law of insider trading does not promote the policies of fairness and equal access to information underlying the federal securities laws. The fiduciary principle narrows the scope of insider trading liability to such an extent that many traders, unfairly using their privileged access to information, are beyond the reach of the statute. As a result, present law is inadequate to curtail widely condemned activity.

Recent attempts by the American Law Institute (ALI), the SEC, and the American Bar Association (ABA) to impose a duty upon these parties have met with only limited success. The ALI’s Federal Securities Code (FSC), for example, makes insider trading illegal subject to certain limited exceptions. Although the FSC imposes a broad duty upon insiders, it fails in its attempt to define the duties of nontippee outsiders, stating that “this area must be left to future judicial development.”
In 1980, the SEC promulgated Rule 14e-3. Section 14(e) of the Exchange Act prohibits "fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer" and gives the SEC the authority to adopt rules defining such acts or practices. Rule 14e-3 adopts an approach similar to the misappropriation theory, requiring anyone in possession of nonpublic information relating to a tender offer, whose knowledge was acquired directly or indirectly from the offeror or the target of the tender offer (including anyone acting on their behalf), to refrain from trading.

Most recently, the ABA, borrowing heavily from the FSC, has urged Congress to adopt a new statutory basis for insider trading liability. Recognizing that "existing statutory authority is too limited to support [a broad prohibition against unfair use of inside information]," the ABA has proposed amendments to the federal securities laws that would address insider trading without reference to the antifraud statutes. In the face of increased public concern over the perceived inequity in unfair outsider trading, a substantive codification of insider trading appears

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76. Exchange Act § 14(e), 15 U.S.C. § 78n(e) (1982). The language in § 14(e) is very similar to § 10(b), though § 14(e) specifically prohibits fraudulent practices and does not include the purchaser or seller requirement found in § 10(b). Because the rulemaking authority under the two sections is so similarly worded, the authority of the SEC to promulgate Rule 14e-3 in light of the Chiarella decision is questionable. See Heller, supra note 5, at 542-43.
77. See supra text accompanying notes 56-57; Heller, supra note 5, at 541-42; see also Securities and Exchange Commission Release No. 34-17,120 (Sept. 12, 1980), 45 Fed. Reg. 60,410, 60,412 & n.20 (1980) (taking the position that Chiarella did not resolve the misappropriation theory under Rule 10b-5 nor limit the SEC's ability to adopt a rule under § 14(e), 15 U.S.C. § 78n(e) (1982)).
79. One proposed alternative states:
   It shall be unlawful for any person, directly or indirectly, . . . to unfairly use material nonpublic information by trading in securities or by selectively disclosing such information to persons who trade; provided that no person shall be liable under this section unless it is proved by a preponderance of the evidence that such person knew (or was reckless in not knowing) that the information was material and non-public and, in the case of selective disclosure, knew (or was reckless in not knowing) that the person to whom the information was disclosed was likely to trade or disclose the information to persons likely to trade.
   ABA Group's Draft Insider Trading Report Seeks New Statutory Basis For Liability, SEC. REG. & L. REP. (BNA) No. 45, at 1785 (Nov. 16, 1984). Other alternatives provide systematic codification of existing Rule 10b-5 case law, but remove the fraud requirements under that rule and establish some statutory exemptions. Id.
80. See, e.g., Louis, The Unwinnable War on Insider Trading, FORTUNE, July 13, 1981, at 72-
necessary. Any legislation, however, must be broad enough to include all parties who trade on inside information even though they may owe no fiduciary duty to the party with whom they trade.

II

INSUFFICIENCY OF THE FIDUCIARY PRINCIPLE

The enactment of the federal securities laws was a significant step forward in supplementing common law principles of fraud and deceit. The acts imposed greater responsibility for fairness in business relationships. Broad judicial interpretation of securities laws' protection has given participants in the securities markets a legitimate expectation that those with whom they trade do not have greater access to market information. This expectation of fairness and honesty in market transactions is the foundation of the American securities industry, ensuring economic growth and continued availability of capital in the financial markets. Although a "seller may not be harmed in theory . . . he still is likely to believe himself harmed if he sold in ignorance to someone who had inside knowledge."\(^8\)

The securities markets have undergone substantial change since 1934. New and more sophisticated methods have been developed to reap the profits of inside knowledge,\(^8\) creating a corresponding need for broad enforcement methods.\(^8\) Chiarella and Dirks, however, sharply limit the scope of the federal securities laws. Although a fiduciary relationship, if it can be found, provides strong incentive and justification for imposing liability upon breaching fiduciaries, the securities laws were not designed merely to codify agency law. Rather, they were primarily concerned with building investor confidence and developing a securities market that would promise fairness, honesty, liquidity, and easy access.\(^8\)

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82. W. PAINTER, supra note 23, at 353 n.19; see also L. Loss, supra note 28, at 608 ("[I]t is important for the markets . . . not merely to do equity, but to appear to do equity."). (emphasis in original).

83. For example, activity in the tender offer and options trading fields often provides rapid, substantial, and generally predictable fluctuations in stock prices and thus generates significant confidential information. See Metz, Use of Inside Data in the Takeover Game Is Pervasive and Can Lead to Huge Profit, Wall St. J., Mar. 2, 1984, at 12, col. 1 [hereinafter cited as The Takeover Game]; infra text accompanying notes 137-39.


A. The Theory of the Exchange Act

As the law of insider trading now stands, a misrepresentation gives rise to an action for fraud, but nondisclosure is actionable only when "one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'" 86 Unfortunately, in adopting the fiduciary principle for impersonal market transactions, the Supreme Court has disregarded the source of the defendant's information and the circumstances under which it was acquired. The Exchange Act does not support this limitation.

In 1934, Congress concluded that in order to create an efficient securities market, it was necessary to compel dissemination of material information regarding publicly traded corporations. Because state laws were considered inadequate to provide the investor protection necessary to preserve the integrity of the financial markets, Congress sought to create a federal statutory structure that would reestablish incentives for capital investment. 87

Investors participate in the national exchanges on the basis of perceived fairness in the market. Fairness is unattainable, however, if some parties gain an informational advantage through means other than superior experience, foresight, or diligence. Congress recognized this unfairness and was concerned not only with the abuse of confidential inside information by corporate insiders, but also with the potential abuse by outsiders who might gain access to inside information and use it for their personal benefit. 88

Therefore, in order to bolster investor confidence in the nation's capital markets, and thus increase investor participation, 89 Congress created a broad scheme of regulation over business conduct that was more strict than the common law. 90 "[The Exchange Act] does no more than insist

87. Shneider, Chiarella v. United States: An Analysis of Judicial Approaches to the Regulation of Business Conduct, 17 NEW ENG. L. REV. 61, 86-88 (1981). Professor Shneider has determined that the thrust of the legislative history as a whole indicates less concern with the unfairness of insider profits than with the losses caused to public investors resulting in the public harm of reduced flow of capital investment due to the public's lack of confidence in the honesty of the securities markets. Id. at 86 (footnotes omitted); see also supra note 17 and accompanying text.
88. 78 CONG. REC. 8296 (1934) (relating to broker/dealers).
89. 78 CONG. REC. 7861 (1934). "The real purpose of this regulatory measure is to protect the investors of the United States against fraud and imprudent investments, and to give integrity to the securities by the sale of which American business must be financed." Id. (remarks of Rep. Lea).
90. Section 10b and Rule 10b-5 have long been interpreted to displace common law requirements in favor of higher goals. The doctrine for which defendant . . . contends [10b-5 inapplicable to total nondisclosure] would tend to reinstate the common law requirement of affirmative misrepresenta-
upon the truth, and it denies an opportunity to one class of investors that has heretofore been denied to others . . . .

Section 10(b) is a broad, catch-all clause designed to prevent manipulative devices. Although the statute does not specifically refer to fraud, the Supreme Court has long interpreted its scope to include fraudulent activity. Rule 10b-5 follows this interpretation; by its very words, it is designed to eliminate fraud. Traditional fraud concepts, however, were built upon cases involving face-to-face transactions. Reliance upon fraud principles to impose duties upon fiduciaries and other parties with even less direct relationships to the injured investor results in a tortured analysis of the statute and law that is “devoid of consistent guiding principle and policy.”

The fiduciary duty doctrine does not stop all unfair trading practices. Although it imposes liability on the core activity that the securities laws were designed to prevent, it fails to limit the actions of parties who have access to confidential information but are outside a traditional relationship of trust or confidence. As the following cases demonstrate, the lower courts have had great difficulty harmonizing the Supreme Court's fiduciary principle with more traditional notions of fairness.

B. Fraud Analysis in Outsider Trading Cases

I. Market Professionals

In Dirks, the Supreme Court created a defense for certain outsiders, arguably in a relationship of trust or confidence, who trade on the basis of inside information. The Court also created a limitation on the right
of other outsiders to trade on that basis. In footnote 14 to its opinion, the Court developed the constructive insider theory of liability. Under this theory, market professionals privy to sensitive information acquired in their service capacity are not allowed to trade on that advantage. The treatment of market professionals as fiduciaries rests on familiar principles of equity and follows from the expectation of trust and confidence generally arising from such relationships.

In some situations, however, the fiduciary principle and the language of footnote 14 may not coincide, thus failing to protect those in arguably arms-length transactions with these professionals. In *Walton v. Morgan Stanley, Inc.*, a corporation hired an investment adviser to search for takeover prospects. The adviser, while in the service of the acquiring corporation, received confidential information from a target company. The information was given to the adviser solely for the use of the acquiring corporation and was not to be otherwise disclosed. When the acquiring corporation declined to make an offer, however, the adviser acted on the inside information and purchased target shares. Since the acquiring corporation did not purchase any shares of the target, the adviser's purchases did not violate any duty owed to the acquiring corporation. In a derivative suit brought by the target company's shareholders against the adviser, the Second Circuit held for the defendant because of the absence of a fiduciary relationship between the target company and the adviser.

The constructive insider theory, however, subjects only a limited group of outsiders to Rule 10b-5 liability—professionals employed by the

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97. *Id.* at 3261 n.14 (1983) (citations omitted):

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 business of the enterprise and are given access to information solely for corporate purposes. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

98. See, e.g., *Restatement (Second) of Agency* § 312 comment c, § 388 comment e (1958).

99. 623 F.2d 796 (2d Cir. 1980).

100. *Id.* at 798-99.
corporation. As a result, the footnote may recover only the ground lost as a result of the direct holding in the *Dirks* case.\textsuperscript{101} Furthermore, non-professional outsiders with access to confidential information of the corporation may remain unreachable under the *Dirks* analysis.\textsuperscript{102}

2. The Temporary Insider

One federal district court has attempted to bridge the outsider enforcement gap remaining after *Dirks* by creating a further category of insider status—the *temporary* insider. In *SEC v. Lund*,\textsuperscript{103} a corporation approached the defendant in order to encourage his financial participation in a joint venture. The defendant declined to join the venture, but subsequently invested heavily in the corporation on the basis of confidential information he had obtained during negotiations.

The rationale of the *Dirks* opinion was insufficient to reach the defendant here; *Lund* was not a fiduciary of the corporation. Furthermore, the corporate insider “was [acting] within the scope of his authority” when he disclosed the confidential information to Lund and thus did not violate a fiduciary duty.\textsuperscript{104} In addition, *Lund* was neither a professional nor “working for the corporation” as required by *Dirks*’ footnote 14. Unable to find liability based on the *Dirks* rationale, the court reasoned that insider trading prohibitions also apply to persons who “become fiduciaries of the corporation and the shareholders” when they “assume the duties of an insider temporarily, by virtue of a special relationship with the corporation.”\textsuperscript{105}

Although *SEC v. Lund* could have been decided under the misappropriation theory, the “temporary insider” analysis is much more advantageous to the defrauded investor.\textsuperscript{106} It puts the temporary insider in a full fiduciary status owing a direct duty of disclosure to the injured shareholders. The constructive insider and misappropriation theories fail to give this protection and thus limit the ability of private claimants to prevail at trial.\textsuperscript{107}

\textsuperscript{101} See supra note 96 and accompanying text.

\textsuperscript{102} See infra text accompanying notes 103-06.

\textsuperscript{103} 570 F. Supp. 1397 (C.D. Cal. 1983).

\textsuperscript{104} Id. at 1402; see also Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980).

\textsuperscript{105} Lund, 570 F. Supp. at 1403.


\textsuperscript{107} See, e.g., infra text accompanying notes 121-36. *Lund*, therefore, returns the primary inquiry to access rather than relationship. In this regard, it may be at odds with *Dirks*, though both *Dirks* and *Lund* concern active involvement with conduct of the business. See Hiler, *Dirks v. SEC—A Study in Cause and Effect*, 43 MD. L. REV. 292, 339-40 (1984).
3. **Creation of Market Information**

Manipulation of the securities markets may also occur when a person is in a position to develop information about a company that, when distributed to the market, will materially affect the price of that company's securities.\(^{108}\) Characterization of this activity as wrongful is not difficult. The trading party occupies an elevated status in the market; his abuse of that position is thus especially offensive to the statutory scheme.\(^{109}\) The difficulty in these cases is that the fraudulent activity often occurs substantially after the defrauding party has entered the market.\(^{110}\) Furthermore, this party rarely has any sort of relationship with the insiders, the corporation, or the trading shareholders. Therefore, it is difficult, if not impossible, to establish a fiduciary or any other relationship between the outsider's wrongful conduct and his trading partner's harm.\(^{111}\)

In *Zweig v. Hearst Corporation*,\(^{112}\) for example, a financial news columnist published a favorable article about a company (ASI) that was to receive assets for stock in an upcoming corporate merger.\(^{113}\) The columnist owned stock in ASI, a fact he failed to disclose before publishing the

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\(^{108}\) Statements that are clearly misleading are, of course, actionable under Rule 10b-5. This Section, however, concerns statements that are not misleading per se but rather are overly optimistic or pessimistic and affect only the market price, not the underlying value, of the security. Furthermore, the party making the statement must be in a position to affect the market price, know his statement will affect the market price, and expect to benefit directly from the rise or fall in the market price.

\(^{109}\) In special circumstances, Congress has granted certain securities professionals the right to trade on informational advantages received as a result of their position in the market. See Exchange Act § 11, 15 U.S.C. § 78k (1982) (exempting market makers, registered odd-lot dealers, specialists and block positioners, bona fide arbitrageurs, and risk-arbitrageurs from § 11's general prohibition against trading by national securities exchange members).

Central to this grant of immunity, however, is the need to maintain a fair and orderly marketplace. Chiarella v. United States, 445 U.S. 222, 233-34 n.16 (1980); see also Dirks v. SEC, 103 S. Ct. 3255, 3262 n.16 (1983); Wang, *supra* note 7, at 1292-93. Therefore, in instances where the trading party's motive is less noble (i.e., for personal profit), the right to trade does not exist.

\(^{110}\) For example, a person hoping to cause an increase in the price of shares will first enter the market and buy securities, then release the fraudulent information. Conversely, if the information will likely decrease the security's price, the party will purchase put options in the security before releasing the information.

\(^{111}\) See, e.g., Zweig v. Hearst Corp., 594 F.2d 1261, 1272 (9th Cir. 1979) (Ely, J., dissenting). Although the fiduciary principle is inapplicable in these cases, courts have had little difficulty in condemning these practices under § 10(b) and Rule 10b-5, reasoning that the person's status in the market, which gave him the ability to manipulate stock prices, provides a presumption of reliance. See also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (registered investment advisory service's failure to disclose its practice of profiting from the market effect of its recommendations was a fraud or deceit upon its clients).

\(^{112}\) 594 F.2d 1261 (9th Cir. 1979).

\(^{113}\) The merger agreement required ASI, the subject of the article, to pay stock worth $1,800,000 at the time of the merger in exchange for the assets of the appellant's corporation. Any increase in the price of the securities, therefore, would reduce the number of securities traded in the transaction. *Id.* at 1265.
arguably misleading story. The other corporate party to the merger (RGC) sued the columnist, claiming that the article had temporarily inflated the price of ASI's stock, thereby reducing the number of shares RGC acquired in the merger. Unable to find a direct duty owed by the defendant to the plaintiffs, the Ninth Circuit imposed Rule 10b-5 liability on the columnist because, in the court's view, he had breached a duty owed to his readers—a duty based largely upon his status in the market.\(^{114}\)

This relationship is insufficient under Chiarella.\(^{115}\) Furthermore, it would not pass muster under the constructive insider theory of Dirks or the temporary insider theory of Lund. Although the defendant arguably occupied a position of confidence with his readers, the columnist had never had a relationship with ASI through which he had "assume[d] the duties of an insider[—even] temporarily."\(^{116}\) Thus, even the broadest expression of the fiduciary principle is insufficient to hold the defendant in this case.

In the spring of 1984, the SEC discovered another instance of outsiders creating market information for personal profit. R. Foster Winans, Jr., as a reporter for the Wall Street Journal, occupied an influential position in the financial marketplace. This position enabled him to affect the price of securities discussed in his columns. Winans, and other parties tipped by him, traded on the knowledge of information to appear in future columns and realized a substantial profit.\(^{117}\) The SEC sought injunctions and disgorgement in a civil suit;\(^{118}\) Winans and two others were indicted by a grand jury on criminal charges of conspiracy and securities fraud.\(^{119}\)

This case differs from Zweig and other cases involving investment advisers because no specific security was recommended or discouraged by the columnist. Nevertheless, each article had a negative or positive

\(^{114}\) Id. at 1266-69.

\(^{115}\) The court found that the columnist's "relationship to the public was not a fiduciary one under common law." Id. at 1269.

\(^{116}\) Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983). Liability to the defendant's readers was not before the court. In order to hold the defendant liable to the nonreading officers of RGC, the court reasoned that RGC had placed reliance on a well-informed market, and deceit against the investors worked as a deceit against RGC. Therefore, the court reasoned, because RGC was the biggest purchaser of ASI stock, RGC should not have to "cover" the loss and, in effect, pay the defendant's damages for him. Zweig, 594 F.2d at 1270.

\(^{117}\) The information contained in the articles was not itself confidential. Rather, Winans and his cohorts traded on the knowledge (belief) that the tenor of the articles would inflate or depress the stock prices. In this regard, the acts were akin to stock manipulation.


tone about the subject company and, therefore, Winans' conduct satisfies the knowledge or expectation of market manipulation required for liability under the Zweig test. The government and the SEC are not relying on the Zweig theory alone, however; both parties intend to apply the misappropriation theory based on breach of the duty owed to the defendant's employer—the Wall Street Journal.

The fact that Winans had a financial interest in his assertions is a material omission that would be important to anyone trading in the market after the report. Under strict fiduciary principle analysis, however, liability is impossible to establish: the columnist and his trading companions were not in a fiduciary relationship with the parties with whom they traded. Under the Zweig theory, the defendants may have had a duty to disclose their personal interest in the subject companies' stock to the readers of the Wall Street Journal. After Chiarella and Dirks, however, successful prosecution of such behavior under the Zweig approach may be blocked by the fiduciary principle.

4. Disparity between Public and Private Enforcement

In a pair of recent decisions arising out of a single set of facts, the Second Circuit has supported criminal convictions based upon the misappropriation theory but denied relief for the unwitting open-market sellers because of their failure to establish a disclosure duty owed to them by the defendants. The inconsistent results in these two cases demonstrate the disparity that now exists between public and private enforcement of policies against insider trading.

In United States v. Newman and Moss v. Morgan Stanley, Inc., the defendants, employees of an investment banking firm and their accomplices, traded in the stock of a target company before public announcement of the tender offer. The defendants had learned of the plans for the tender offer in their employment capacity. The information was passed from a Morgan Stanley, Inc. employee to an employee at Kuhn, Loeb & Co., another investment banking firm, who in turn told Newman, a stockbroker.

The Newman case thus involved facts very similar to those in Chiarella. In Newman, however, the Justice Department specifically drafted the indictment to include the theory of liability left unresolved in Chiarella: the government claimed that the defendants had breached a

120. "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important [in arriving at a decision]." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); see also List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), cert. denied, 382 U.S. 811 (1965).


duty owed to someone other than the shareholders of the target company. Unable to find a breach of a fiduciary duty between the defendants and those with whom they traded, the government charged the employees with breaches of the fiduciary duty of silence owed to their employers—a breach sufficient to support a conviction.

The Second Circuit held that by misappropriating the information entrusted to them by their employers, and by failing to respect the confidentiality of their employers' clients, the employees had committed a fraud against the employers and their clients. The court also reasoned that since the defendants' trades probably increased the market price of the target companies' shares, the trading activity constituted a further fraud against the acquiring corporations.

123. The government asserted that the defendant should be held liable for a breach of a duty of silence owed to his employer or employer's customers (the acquiring corporations). In Chiarella, the jury had not properly confronted that question at trial, and the Court refused to consider this theory. Chiarella v. United States, 445 U.S. 222, 236-37 (1980); id. at 238 (Stevens, J., concurring).

124. Newman, 664 F.2d at 15-16. Other defendants involved in the wrongful trading were held liable through a conspiracy with the employee. Id.

Analysis of a duty under the misappropriation theory focuses sharply upon the source of the inside information. The defendant charged with misappropriation has a relationship with either the insiders, or, in cases involving tender offers, with parties in the market for the target corporation's shares. His conversion of information rightfully belonging to these parties is a breach of his duty thereto. See, e.g., RESTATEMENT (SECOND) OF AGENCY § 388 comment c (1958). As explained in United States v. Reed, [Current Binder] FED. SEC. L. REP. (CCH) ¶ 91,927, at 90,603 (S.D.N.Y. Jan. 24, 1985) (emphasis in original) (citations omitted):

The misappropriation of secret information for personal aggrandizement in breach of such a relationship constitutes fraud. The origins of this approach can be traced to the law of restitution. A person who receives confidential information from another and misappropriates it for personal benefit is deemed to hold the proceeds of the misappropriation in a constructive trust for the benefit of the entrusting party. The misappropriator thus becomes the trustee ex maleficio, or quasi-fiduciary, of the entrustor. In the context of the securities laws, it does not matter for purposes of assessing liability whether the recipient of the information is actually trading in the securities issued by the source of the information. Rather, the duty is breached by the misappropriation and resulting profit, and a constructive trust attaches.

See also Langevoort, supra note 2, at 30-31 & n.121.

125. Newman, 664 F.2d at 17. The employers' clients had provided the information with the expectation that it would remain confidential and be used only for corporate purposes. Cf. Dirks v. SEC, 103 S. Ct. 3255, 3261, n.14 (1983); supra text accompanying notes 97-102.

126. Newman, 664 F.2d at 17-18. The Supreme Court would probably hold that a simple interest in the target company by the acquiring companies does not merit Rule 10b-5 protection. See Piper v. Chris-Craft Indus., 430 U.S. 1 (1977) (similar holding under § 14(e) of the Exchange Act); see also Note, Trading on Confidential Information—Chiarella Takes an Encore: United States v. Newman, 56 St. John's L. Rev. 727, 738-40 (1982). In addition, the misappropriation theory under Rule 10b-5 may have little justification after Dirks v. SEC, 103 S. Ct. 3255 (1983). According to Dirks, Rule 10b-5 liability requires an insider's breach of a duty. Id. at 3268. In most cases involving misappropriation, however, the defendant has breached a duty to the source of the information—usually his noninsider employer. See Langevoort, supra note 2, at 46.

Nevertheless, the Second Circuit has firmly established its acceptance of the theory. In SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), a case sharing facts virtually identical to Chiarella, the court held that the defendant employee had breached a duty of confidentiality to his employer, a financial printer. The court emphasized that Rule 10b-5 liability need not be based only upon a duty to
While the misappropriation theory is applicable when used by a governmental agency engaged in protecting the integrity of the market, the Second Circuit has denied its use in a private damages action. In Moss v. Morgan Stanley, Inc., the plaintiff sued on behalf of the class of investors who had sold stock in the target company on the days the defendants were also trading.\textsuperscript{127} The district court dismissed the complaint for failure to state a cause of action under the Exchange Act.\textsuperscript{128}

On appeal, the plaintiff proposed three different theories of liability: the employees of an investment banking firm owed a “disclose or abstain” duty to the target shareholders; the employee was an insider of the target company after receiving confidential information regarding the target; and Morgan Stanley, Inc., as a broker-dealer, owed a general duty to the market to disclose inside information before trading.\textsuperscript{129} Moss also tried to circumvent Chiarella through use of the misappropriation theory. He argued that the defendants, having “stolen” the information regarding the tender offers from the acquiring companies’ investment banker, should be held to “a general duty of disclosure to the entire marketplace.”\textsuperscript{130}

The Second Circuit rejected all of the appellant’s arguments and affirmed the district court’s judgment. The appellate court ruled that no fiduciary duty could be established and thus the defendant did not breach any duty owed to the plaintiff.\textsuperscript{131} The court also rejected the misappropriation theory, relying on Chiarella. Use of the misappropriation theory, the court felt, would impose liability even absent a special relationship between the two parties. Such an approach would “[create] . . . a new species of ‘fraud’ . . . [which] ‘should not be undertaken absent some explicit evidence of congressional intent.’”\textsuperscript{132} With “no [fiduciary] duty in the air” to which any plaintiff [could] attach his claim,\textsuperscript{133} the complaint was dismissed.

disclose. \textit{Id.} at 202-03. According to the court, the duty to the target company shareholders could only be important in the context of a private suit for damages; it is irrelevant to an inquiry into whether the rule was violated. Therefore, even though the defendant traded in shares of the target corporation, his breach of a duty owed to his employer was sufficient to satisfy the “upon any person” language of the rule. \textit{Id.}

\textsuperscript{127} 719 F.2d 5, 9 n.2. (2d Cir. 1983), cert. denied, 104 S. Ct. 1280 (1984).
\textsuperscript{129} Moss, 719 F.2d at 13-15.
\textsuperscript{130} \textit{Id.} at 15. The court found that “none of the defendants occupied a position of ‘trust’ with respect to [the plaintiff].” \textit{Id.} at 11-12. Furthermore, the court held the “constructive insider” theory, \textit{see supra} text accompanying notes 97-102, inapplicable because the defendants were “‘complete stranger[s] who dealt with the sellers . . . only through impersonal market transactions’ ” and therefore the relationship did not imply an expectation of silence. \textit{Id.} at 15 (quoting Chiarella, 445 U.S. at 232-33).
\textsuperscript{132} \textit{Id.} at 16 (quoting Chiarella, 445 U.S. at 233).
\textsuperscript{133} \textit{Id.} at 13.
The incongruous results in the Moss and Newman cases underscore the deficiencies of the fiduciary principle. Under the same set of facts, the government is able to obtain a criminal conviction in order to protect the reputation of the nontrading employer Morgan Stanley, while the private investor is denied recovery from a party engaged in clearly wrongful activity simply because no fiduciary duty exists between the parties.134

The Moss case is also distinguishable from the Supreme Court's insider trading decisions. In contrast to Dirks, the Moss defendants' activities were criminal and clearly undertaken for the defendants' personal benefit. Furthermore, the Moss defendants operated with knowledge that trading would injure any market seller within the same period.135 The plaintiffs suffered monetary loss and probably would have had a successful claim if the transaction had involved traditional insiders or had been conducted face-to-face.136

Finally, in Dirks, the Supreme Court placed great emphasis upon the need to preserve the role of market analysts. There is no similarly compelling public policy argument available in Moss. As the criminal conviction in Newman indicates, the defendants were merely thieves, unjustly enriched at the expense of those with whom they traded. The overriding policy of maintaining fair and liquid securities markets, where all investors feel confident that they are not simply gambling with loaded dice, compels an opposite finding.

5. Options Trading

Trading in derivative securities137 is particularly subject to abuse of inside information because it provides opportunity for large gains relative

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134. The Moss court also considered Rule 10b-5 the government's remedy, requiring private plaintiffs to meet stricter standing requirements. Since both Chiarella and Dirks were government actions, the Supreme Court has yet to confront this issue squarely. But see Blue Chip Stamps v. Manor Drug Stores, Inc., 421 U.S. 723 (1975) (limiting standing in private suits to actual purchasers or sellers of the securities); see also Chiarella v. United States, 445 U.S. 222, 238 (1980) (Stevens, J., concurring).

135. The defendants' activities, including use of secret bank and trust accounts and spreading purchases among brokers to avoid detection, indicate that they were aware their actions were improper. Newman, 664 F.2d at 15.

136. In a traditional insider trading case involving corporate officers or directors purchasing shares on the open market, a plaintiff would face no barriers to maintenance of a Rule 10b-5 action for fraud. Although in both “insider” and “outsider” trading situations the plaintiff has been identically injured, the incidence of a fiduciary relationship forces completely disparate results. See Brudney, supra note 58, at 332-33; Wang, supra note 7, at 1221-24; Comment, Civil Liability for Insider Trading Under Rule 10b-5: Should It Depend on Fiduciary Relationships?, 1982 Ariz. St. L.J. 965, 980.

137. Derivative securities include options, warrants, puts, calls, and other instruments related to the market activity of a security. For simplicity, this Comment uses the inclusive term “options trading” and refers to the securities themselves as “options.”
to the amount of investment at risk. Moreover, it is virtually impossible to prevent informational abuses involving derivative securities through application of the fiduciary principle.

Option traders are not shareholders at the time of the transaction. Rather, they are investors simply "betting" on the future price movements of the underlying securities. Accordingly, it is especially difficult to establish a specific relationship of trust and confidence between the corporate insider who trades in the options and the option trader on the other side of the transaction.\textsuperscript{138} Chiarella and Dirks thus cast considerable doubt on the applicability of Rule 10b-5 to police this activity.

The Insider Trading Sanctions Act of 1984 expressly extends prohibitions against insider trading under the Exchange Act to stock options trading.\textsuperscript{139} Since the amendment does not alter the underlying case law, however, it is difficult to predict how courts will reconcile the fiduciary principle with the activities of option traders.

\section*{III \hspace{1cm} CORPORATE RECOVERY OF THE OUTSIDER'S GAIN: A LEGISLATIVE PROPOSAL}

The current scope of liability under Section 10(b) and Rule 10b-5 is inadequate to deal properly with outsiders trading on inside information. The fraud-based rule, long used as a catchall tool to reach a broad range of wrongful behavior, cannot extend to activities not involving fraud.\textsuperscript{140} Attempts to characterize outsider trading as fraudulent or to analyze it in terms of common law fraud concepts will require years of litigation with little prospect for clear or consistent results.

The recent development of transactions and securities with particularly volatile effects on stock prices has compounded the outsider trading problem. Corporate mergers and takeovers generate substantial amounts of confidential information, the use of which is highly profitable and vir-


\textsuperscript{140} Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473-74 (1977); \textit{see also} supra text accompanying notes 92-95. \textit{But see} SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984).
tually risk free. Derivative securities, such as options and warrants, provide for large returns on relatively small investments. Faced with tempting opportunities for tremendous profit, and with little fear of detection, outsiders with access to confidential information are increasingly capitalizing on their special knowledge. As a result, government enforcement agencies are overburdened and cannot adequately police the market. Rather, they must rely on the legal sanctions currently available to deter insider trading. Unfortunately, the Supreme Court's fraud analysis has limited the effectiveness of these legal sanctions.

As the cases described in Part II demonstrate, the fiduciary principle has proved insufficient to reach outsiders trading on inside information. By limiting the scope of liability under Rule 10b-5, the fiduciary principle allows some parties—strangers to the corporation and its shareholders, but with access to confidential information concerning the corporation—to trade on that information with impunity. The activity of at least some of these parties is no less detrimental to investor confidence in the securities marketplace than the trading activity of traditional insiders. Therefore, it should be curtailed.

The Supreme Court, however, is unlikely to abandon the fiduciary principle so long as the underlying violation is based on fraud. Moreover, any SEC rule designed to combat outsider trading must rely on fraud analysis as well. Yet only a convoluted interpretation of traditional fraud notions will lead to an effective outsider trading rule. Therefore, Congress must address the issue directly. Specific legislation, no longer tied to the general antifraud provisions of the federal securities laws, can impose liability upon the unfair access or use of confidential information, coordinate damages assessments with the culpability of

141. See generally The Takeover Game, supra note 83, at 8, col. 1.

142. H.R. REP. No. 355, supra note 4, at 6, reprinted in 1984 U.S. CODE CONG. & AD. NEWS at 2279. Defendants in Rule 10b-5 suits brought by private plaintiffs have argued that the securities laws provide adequate sanctions against violators of § 10(b) and Rule 10b-5 in the form of governmental sanctions. Nevertheless, these sanctions and the private remedy are not mutually exclusive. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 241 n.18 (2d Cir. 1974). Rather, "[p]rivate enforcement . . . provides a necessary supplement to Commission action." J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (interpreting § 14(a) of the Exchange Act); see also Chris-Craft Indus. v. Piper Aircraft Corp., 480 F.2d 341, 356 (2d Cir. 1973), rev'd in part, aff'd in part, vacated in part, 516 F.2d 172 (2d Cir. 1975), rev'd, 430 U.S. 1 (1976).

143. The broad reversal of an important judicial interpretation of a legislative statute is better left to Congress. See, e.g., Chiarella v. United States, 445 U.S. 222, 233 (1980).

144. In order to deter insider trading effectively, liability could be drawn as broadly as possible: an absolute proscription against trading by anyone in possession of inside information. This standard would be both clear and subject to a relatively simple test at trial. Nevertheless, an absolute duty to disclose or abstain would act as a disincentive for some beneficial market activity. For example, it would discourage market analysts from diligently pursuing market research by eroding the profitability of these efforts. See Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 CORNELL L.Q. 53, 56-57 (1960) ("The party who has been diligent in reducing some of the market uncertainties to fact is not required to come forth and offer this information to the less
wrongful behavior, and provide for full deterrence through a consistent scheme of public and private enforcement.

Congress should therefore grant a private right of action to recover the unjust enrichment whenever a trader has unfairly acquired an informational advantage and has unfairly used that advantage to benefit from unsuspecting parties. Because of problems inherent in private suits, however, this private right of action should accrue only to the corporation whose shares have been traded. Furthermore, to avoid the difficult exercise of trying to match an investor's injury with the insider's conduct, the basis of the recovery should not focus on injury. Instead, the proposed remedy shall seek disgorgement of the benefit gained by the defendant. Recovery of unjust enrichment, however, does not by itself fully promote either deterrence or compensation. Therefore, to create a more effective insider trading deterrent, the proposed corporate recovery provides for treble damages. The corporation will retain one-third of any recovery under this proposal to furnish adequate incentives for litigation. The remaining two-thirds will be held in trust, subject to the super-


145. "[T]he real objection to insider trading . . . is based on the defendant's unfair use of a privileged position. . . . The argument that the defendant should have refrained from insider trading . . . supports only a restitutionary claim by the corporation and does not create rights in any individual shareholder." Dooley, supra note 7, at 37-38 n.169.

146. Id. at 33; Langevoort, supra note 2, at 7-8; Wang, supra note 7, at 1221-24.

147. See RESTATEMENT OF REsrrtution § 1 (1937); see also infra text accompanying notes 175-92.

148. Mere disgorgement of benefit simply returns the defendant to his original status. Furthermore, a defendant's gain is always less than the losses suffered by contemporaneous traders trading in the opposite direction. See infra note 191.


Under the corporate recovery provision proposed here, the maximum amount of civil damages recoverable would be three times the defendant's gain (or loss avoided) as a result of his trades. Government agencies would still be permitted to sue, and if the corporation is not involved in the suit, seek damages. Recovery of damages, however, would be a superior right of the corporation, thus limiting government agencies to injunctions and criminal sanctions. See also infra note 204.
rior claims of injured investors. Finally, purchasing defendants must dispose of their holdings so that they do not indirectly benefit from the corporation's recovery.

A. Standards for Liability

1. The Unfair Use of Confidential Information

To successfully deter insider trading, the statute must pave the way to easier adjudication, eliminating lengthy considerations of all issues other than the unfairness of the defendant's actions. For example, proof of some relationship giving rise to a duty to disclose need not be considered. The trader who uses surreptitious means to obtain information is unreachable under Rule 10b-5 analysis; his inside information was acquired without a breach of fiduciary duty. Such activity clearly falls outside traditional notions of fairness, however, and thus may be curtailed by a statute prohibiting unfair activity.

Likewise, liability under a fairness-based system is premised upon the defendant's wrongful behavior rather than the plaintiff's injury. Therefore, requirements that the injured plaintiff bring suit and that the defendant act with specific injurious intent may be eliminated. Rule 10b-5 fraud analysis, focusing upon the plaintiff's injury, retains these requirements. Injury, however, would not be the primary consideration under a fairness statute, thus freeing the courts to address the defendant's behavior directly.

Finally, in addition to ferreting out unfairness, any liability standard should clearly reflect the overriding deterrence goal. Although investor compensation is also important, it raises theoretical problems when applied to impersonal market transactions. Thus, where it conflicts

150. "Injured investors" can broadly be defined as the persons buying or selling securities contemporaneously with the defendant. See Wilson v. Comtech Telecommunications Corp., 648 F.2d 88 (2d Cir. 1981) (duty of disclosure owed only to those traders trading contemporaneously with the insider); cf. SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983) (measuring the damages a reasonable time after dissemination of the information). In government actions, the treble damage recovery would be held by the government, subject to similar restrictions. See also infra note 204.

In cases where the recovery is too small or the class of injured investors is too large to make distribution to shareholders cost effective, the money could be retained by the corporation, or by the SEC or the Department of Justice to aid their enforcement efforts. Cf. P. SEC. CODE § 1711(j)(2)-(3) (1980) (depositing recovery with the Securities Investor Protection Corporation).

151. See, e.g., Dirks v. SEC, 103 S. Ct. 3255, 3261 (1983); Chiarella v. United States, 445 U.S. 222, 228 (1980); see also Wang, supra note 7, at 1289.

152. See infra text accompanying notes 175-92.


154. See infra text accompanying notes 200-01.

155. See, e.g., Karjala, supra note 13, at 629-33. For example, compensation presupposes a
with the need to deter unfair trading, compensation shall be a secondary consideration only.

Inevitably, the proposed unfairness standard will be imprecise. The parameters of liability nonetheless should be left to judicial analysis. Although strained judicial construction under Rule 10b-5 thus far has been sufficient to reach outsider trading, under a new standard free from fraud constraints the breadth of coverage can be much wider. "Unfair activity," however, may be broadly interpreted to include activities that are beneficial to the smooth functioning of the securities markets. Therefore, some guidelines regarding the scope of liability are required.

2. Limitations on Liability

The degree of culpability in an outsider's acquisition of confidential information may run from the legitimate exercise of superior analytical skill and technical judgment to purposeful illegal efforts. Only the most culpable defendant should be subject to full treble damages liability. Therefore, in drawing distinctions between different types of behavior and in imposing sanctions, courts must consider several factors. First, the court should analyze the unfairness of the trader's access to the information and the unfairness of his use of the information. Second, the court should determine the defendant's knowledge of the nonpublic nature of the information and the willfulness with which he acted. Finally, the court should examine the need to deter the type of activity at issue in the litigation and, if this proves indecisive, the need to provide compensation in order to buoy investor confidence.

Parity of information is not the goal of this unfairness standard. The fact that information is not widely known should not prohibit its use per se. This proposal instead seeks to promote equal access to information. Judicial analysis must therefore focus on the propriety of the trading party's acquisition and use of the confidential information rather than merely on his nondisclosure of the information.

For example, a party may take a series of publicly available facts,
immaterial in themselves, and use analytical skill to weave them into a "mosaic" having material significance. The analyst's access to publicly available information is clearly fair. Moreover, his subsequent use of the information for personal benefit is fair. Through his own diligence and skill, the analyst has assembled something of value in which he has a proprietary interest. This behavior is beneficial to the marketplace and as a policy matter should be encouraged.

Other instances will fall somewhere between the beneficial activity of market analysts and the harmful activity of those trading on stolen information. While difficult cases will always exist, distinctions can be based upon the factors set forth earlier. Misappropriation, for example, may not always be characterized by the highest degree of wrongful intent. The trading party's access to the information is lawful, and he may feel his inside position warrants additional reward or he may be ignorant about the confidentiality of the information he has acquired. On the other hand, use of the misappropriated information often is characterized by willfulness and knowledge of the informational advantage, and can therefore be unfair. The need for deterrence in such situations is acute since parties who trade on the basis of information acquired through a positional advantage significantly affect investor confidence in market integrity. Nevertheless, because of the possibility of reduced culpability, misappropriation need not always trigger treble damages.

The party who occupies an influential status in the market, enabling him to create market information and profit thereby, presents a more troublesome liability problem. In the context of this activity, it is difficult to separate beneficial market research from harmful market manipulation. Therefore, in such cases, the court must carefully balance the party's affirmative abuse of his positional advantage with the potential chilling effect liability would impose upon beneficial research efforts.

To the extent that the party has utilized independent effort to arrive at a decision, liability should not attach; this access is fair. Furthermore, Congress has specifically exempted from liability the trading activity of certain securities professionals who "contribute to a fair and orderly marketplace." Their access to the information is fair and the subsequent use is beneficial to the marketplace; therefore, these parties may

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160. Misappropriation can be distinguished from illegal acquisition. A party misappropriating information has been given lawful possession of the information subsequently used for an unlawful purpose, while the thief has never had a lawful right to possess the information. Dirks v. SEC, 103 S. Ct. 3255, 3267 (1983).

utilize informational advantages obtained through their position, at least to some degree. On the other hand, if the trades are based upon confidential information valuable in and of itself, or made valuable solely due to the party’s status in the market, these market efficiency notions do not apply to protect the trading party from liability. Instead, his abuse of position, coupled with the highest degree of knowledge and willfulness, compels an opposite finding.

It is probably most difficult to find liability, even under an unfairness standard, when inside information is accidentally tipped. The trading party has not unfairly acquired the information. Furthermore, his use of the information might not be unfair, depending on his knowledge of the nonpublic nature of the information. Most important, deterrence is generally not necessary in these cases—the insider’s disclosure was unintended and the potential for recurrence, therefore, will not be improved by increased enforcement. Finally, the nonpurposeful nature of the entire event does relatively little to shake investor confidence.

Regardless of the degree of culpability associated with insider trading activity, any reform must impose a strict duty on outsiders to abstain from trading, unless disclosure is both permissible and achievable. Outsiders who gain unfair access to information generally should be prevented from disclosing that information to the general public. The corporation may have a justifiable reason for maintaining secrecy, and the outsider should not be allowed to disrupt that business purpose. Moreover, even if the outsider’s access is lawful, contractual obligations and agency principles may prohibit disclosure without the corporation’s permission. Therefore, abstinence usually is the only lawful alternative.

B. The Corporate Right of Action

The deterrence goal of the federal securities laws is best served when suit is brought against the wrongfully trading party, regardless of who benefits. The corporate right of action will more effectively deter insider and outsider trading by ensuring that its legality will be tested in the courts. In most cases, the corporation whose shares have been traded has not been directly harmed. Nevertheless, even though corporate recovery allows the corporation to benefit from the wrongdoing of its

162. In SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984), for example, an unintentional tip was sufficient to preclude liability of the tippee who traded on the information with knowledge of its confidential nature.

163. Outsiders may effectively disclose information by informing a person associated with a financial newspaper or other media groups. In the event the media declines to announce the information, however, see Dirks v. SEC, 103 S. Ct. 3255, 3256 (1983) (Wall Street Journal declined to publish market analysis story regarding fraud allegations), the outsider may be unable to disclose the information adequately, and thus must be prevented from trading.
affiliates, the corporation may be the best plaintiff and a good repository for the defendant’s restitution.

The corporation has several incentives to bring suit, at least if all corporate managers are not involved in the wrongdoing. Insider trading may injure the corporation’s reputation, thereby affecting its ability to attract clients or to maintain a market in its shares. As a result of depressed stock prices and shaky investor confidence, future efforts to raise additional capital may be severely impaired. Moreover, insider trading may lead to information distortion, delays in information distribution, and competition among employees with access to inside information; therefore, insider trading prohibitions may “enhance business decision-making.” Finally, corporate officers with knowledge of wrongful activity may incur liability for failure to prevent the trades or for failure to pursue the corporation’s cause of action against the wrongful trader.

The corporation is also well positioned to administer distributions to those investors claiming rights to the fund, as it has the best access to information concerning current and prior shareholders. In addition, corporate recovery alleviates the procedural burdens of class claims. Finally, the corporation can hold the fund in a trust account, thereby benefiting the injured parties during the holding period and avoiding unnecessary governmental administrative costs.

Mere inclusion of a new plaintiff will not adequately improve enforcement of informational abuses, however. The pitfalls of private corporate recovery may overshadow the benefit. The basis for recovery may retain burdensome standing requirements, forcing the plaintiff to show actual injury. The level of recovery may be insufficient to encourage lawsuits or may be insufficient to compensate the investors’ injury. Additionally, the corporation may be unwilling to bring suit, necessitating action at the investor level. As discussed below, however, the proposed legislative enactment will effectively eliminate or avoid many of these concerns and provide adequate enforcement and deterrence of insider trading abuses.

164. If management is involved, a limited private action right is available. See infra text accompanying notes 204-11.
166. Haft, The Effect of Insider Trading Rules on Internal Efficiency of the Large Corporations, 80 MICH. L. REV. 1051, 1053 (1982); see also Karjala, supra note 13, at 643 n.63. But see Wang, supra note 7, at 1245-47.
167. See, e.g., Mosser v. Darrow, 341 U.S. 267 (1951) (bankruptcy trustee liable for the trades of others even though trustee did not personally gain).
168. L. Loss, supra note 28, at 665 (suggesting imposition of liability on innocent but knowledgeable corporate managers for failure to protect a corporate asset).
I. Private Corporate Recovery

Private recovery is a powerful and inexpensive method for deterring insider trading activity and thereby promoting market fairness and investor confidence. Nonetheless, it is not without risk. The federal courts have restricted private remedies in securities litigation largely because of three concerns: private actions may not improve detection beyond current SEC capabilities, private actions can lead to vexatious litigation, and a multiplicity of private actions might impose unreasonable financial penalties upon defendants. The corporate right of action proposed in this Comment avoids many of these perceived drawbacks.

In recent years, private suits have often been brought in the wake of SEC investigations. If private parties are indeed unable independently to discover instances of insider trading, a private right of action will not ease the SEC's burden or increase enforcement of the law. Unfortunately, individuals generally do not have the surveillance machinery of the SEC at their disposal. In addition, litigation costs, meager damage awards, and rigorous standing requirements often bar individual plaintiffs. These barriers can be overcome, and the efficacy of private enforcement actions improved, if the corporation is granted a statutory right of recovery.

Private corporate actions could mitigate the SEC's enforcement burden. Although government enforcement agencies are well equipped to detect insider trading activity, most insider trading cases are based primarily on circumstantial evidence. Corporate officers are better positioned to examine the facts, to marshal informants, and to find other insiders who are willing to testify about activities within the organization. Furthermore, if investor suits are permitted on a limited basis, corporations will be assisted in their investigative efforts by a battery of private lawyers eyeing contingency fee awards—a force government agencies cannot hope to match. Finally, the mere threat of private recovery should deter much of the proscribed activity.

Courts have also restricted private rights of action on the assump-

170. See, e.g., Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740-47 (1975) (limiting the judicially created private cause of action under Rule 10b-5 because of a perceived need to protect the courts from a deluge of unwarranted private damages claims); see also Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976) (criticizing unreasonable damage awards in civil actions), cert. denied, 429 U.S. 1053 (1977); cases cited supra in note 49.


173. See infra text accompanying notes 204-11.

174. Kajala, supra note 13, at 638 n.38.
tion that they merely encourage frivolous lawsuits, particularly if a treble damages award exists. Even if enforcement efforts increase, a plethora of unwarranted “strike” litigation will not improve the integrity of the securities market. Moreover, such litigation will increase the workload of an already overburdened judicial system. A corporate recovery, however, will not impose these risks. By adding only one plaintiff to each transaction, the proposed statute does not increase the potential for frivolous suits significantly. Furthermore, the proposed statute does not directly benefit the corporation beyond a full (untrebled) recovery at most, thus eliminating any undesirable impetus provided by treble recovery.

Finally, corporate recovery based upon restitution principles prevents unreasonable private damages awards. As discussed in the next Section, the defendant’s obligation under this proposal is limited by a natural ceiling—a multiple of his profit from the transaction.

2. Restitutionary Basis for Recovery

Private relief in most insider trading cases has focused on tort recovery, requiring compensation sufficient to make the plaintiff whole. This has occurred because the private right of action under Rule 10b-5 is based primarily on tort law. By removing the basis of recovery from tort principles requiring specific intent, causation, reliance, or fiduciary relationships, restitutionary recovery eliminates many of the difficulties inherent in the fiduciary principle and allows enforcement against a broader spectrum of wrongfully acting parties. The law of restitution requires “[a] person who has been unjustly enriched at the expense of another . . . to make restitution to the other.” Restitution is an effective deterrent because its measure of recovery is based solely on the amount and unjustness of the enrichment, and not on the damage to the other party. If a party profits as a result of abusing a positional advantage, he must surrender his benefit.

177. RESTATEMENT OF RESTITUTION § 1 (1937); see id. § 1 comments a, d, e; RESTATEMENT (SECOND) OF AGENCY § 388 comment c (1958); see also Dirks v. SEC, 103 S. Ct. 3255, 3265 (1983) (“[T]he test [for insider trading liability] is whether the insider personally will benefit, directly or indirectly, from his disclosure.”); Diamond v. Oreamuno, 24 N.Y.2d 494, 498, 248 N.E.2d 910, 912, 301 N.Y.S.2d 78, 81 (1969).
179. RESTATEMENT OF RESTITUTION § 200 (1937). Under the statute proposed in this Com-
Some state courts, following this reasoning, have imposed restitutionary liability on corporate agents who compete with their corporations in the purchase of securities. In *Brophy v. Cities Service Co.*, for example, a corporation intended to repurchase a substantial block of shares. A corporate employee purchased stock on this confidential information, which he had acquired by virtue of his position. The stock price rose as a direct result of the corporation's purchases, and the defendant profited. The court, however, disregarded the defendant's argument that the corporation had not suffered harm. It found that loss to the corporation was unnecessary in an unjust enrichment case, and held the defendant liable to the corporation for all profits gained.

In *Diamond v. Oreamuno*, the New York Court of Appeals granted corporate recovery in a derivative suit against corporate insiders for profits made as a result of trading on inside information. As a threshold matter, the defendants maintained that their activity had not harmed the corporation and that the corporation, therefore, was an improper plaintiff. The court, however, noted that the purpose of a derivative action is to prevent corporate impropriety rather than to compensate the shareholder. Corporate injury thus was not "an essential requirement for... a breach of a fiduciary duty." Accordingly, the court permitted the corporation to recover all profits derived from the defendants' transactions.

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180. 31 Del. Ch. 241, 70 A.2d 5 (1949).

181. Id. at 244, 70 A.2d at 8; see also Thomas v. Roblin Indus. Inc., 520 F.2d 1393, 1397 (3d Cir. 1975); cf. Schelin v. Chasen, 313 So. 2d 739, 746 (Fla. 1975) (holding that "actual damage... must be alleged in the complaint to substantiate a stockholder's derivative action").


183. Diamond, 24 N.Y.2d at 498, 248 N.E.2d at 912, 301 N.Y.S.2d at 80; see supra text accompanying notes 165-66; see also Walton v. Morgan Stanley & Co., 623 F.2d 796, 798 (2d Cir. 1980).

184. The *Diamond* decision has been roundly criticized by both state and federal courts. See, e.g., Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978) (no corporate recovery absent actual corporate injury); Schein v. Chasen, 313 So. 2d 739 (Fla. 1975) (same).
While *Brophy* and *Diamond* involved corporate insiders, restitutionary recovery is equally effective against parties who are not in direct fiduciary relationships with the corporation. Section 201(2) of the *Restatement of Restitution* provides:

[w]here a fiduciary in violation of his duty to the beneficiary communicates confidential information to a third person, the third person, if he had notice of the violation of duty, holds upon a constructive trust for the beneficiary any profit which he makes through the use of such information.\(^{185}\)

This section of the *Restatement* places primary reliance on the culpability of the outsider tippee. Knowing receipt of inside information obtained through the breach of a fiduciary tipper, where that information is used for the tippee’s profit, gives rise to a corporate right of restitution.\(^ {186}\)

Section 16(b) of the Exchange Act\(^ {187}\) supports restitutitional recovery as well. The statute avoids all reference to fraudulent activity, simply declaring that “the unfair use of information” obtained as a result of a “relationship to the issuer” is unlawful. Recognizing that specific injury is often impossible to prove in insider trading cases, the statute instead requires the insider to forfeit his profit to the corporation.\(^ {188}\)

Restitutionary recovery also serves to limit the scope of liability imposed on defendants in private actions. In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,\(^ {189}\) the court found that the defendants owed a duty to the entire marketplace. Therefore, the defendants’ liability was not limited to those actually purchasing the same shares the defendants sold, but to all purchasers buying during the time the defendants were in the market.\(^ {190}\) This was an extreme view, exposing the defendants to huge potential liability,\(^ {191}\) and has not been followed, even

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\(^ {185}\) *Restatement of Restitution* § 201(2) (1937).


An insider receives a benefit in the form of a special advantage when he trades on the basis of inside information. But he is only benefited because the corporation has elected not to disclose that information to the market. Were the corporation to make a general disclosure prior to an insider’s trade, the advantage would be eliminated and the information would be of no special value to the insider. Thus, the insider’s benefit is conferred by the nondisclosing corporation. Since this benefit is gained wrongfully from the corporation, the corporation ought to be entitled to restitution for the insider’s unjust enrichment.

The “misuse of corporate asset” theory, however, is typically unhelpful, since in most cases the corporation cannot take pecuniary advantage of inside information without violating the federal securities laws. In these cases, damage to the corporation is more tenuous. Karjala, *supra* note 13, at 641-42 & n.60.


\(^ {188}\) *Id.*

\(^ {189}\) 495 F.2d 228 (2d. Cir. 1974).

\(^ {190}\) *Id.* at 241.

\(^ {191}\) Under the *Shapiro* test, liability is always greater than the defendant’s actual profit. Many
in the Second Circuit. Recovery based upon restitution limits the damages to the defendant's gain, thus putting a realistic cap on the potential liability under a private right of action.

3. Treble Damages

Because of the difficulty faced by private litigants relying on the fraud-based fiduciary principle, the level of expected liability under a simple disgorgement rule does not adequately discourage persons from trading on inside information. Likewise, the level of expected private recovery does not adequately encourage suits by private plaintiffs. Enforcement can be improved if either the potential gain to be realized upon successful completion of litigation is increased, or the cost of bringing suit is reduced. Corporate recovery of treble damages, therefore, meets at least four objectives in insider trading enforcement. The corporate cause of action reduces the economic costs of detection and litigation. In addition, it provides a stronger deterrent to those contemplating trading on inside information, a stronger incentive for private plaintiffs to bring suit against those traders, and an increased pool of money from which to compensate the investors who have realized losses as a result of the defendant's abuse of inside information.

If a party is motivated to act wrongly by desire for economic gain, an economic penalty provides an effective deterrent. Compliance with the law only occurs if the potential wrongdoer believes that he would lose more by trading than by abstaining. The current monetary sanction in private insider trading cases is merely the insider's gain. After losing in litigation, the insider is in roughly the same position as before the trade; if he wins, he is enriched to the extent of his profit. If the risk of

192. Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 170 (2d Cir. 1980) (reversing trial court's award of damages to all persons trading in opposite direction while information was undisclosed and limiting total damages to amount of tippee's unfair profit); see also Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976) (strongly criticizing the Shapiro reasoning), cert. denied, 429 U.S. 1053 (1977).


194. The plaintiff's expected level of damages under a disgorgement rule will be the defendant's profit, multiplied by the plaintiff's probability of winning. Since the fiduciary principle narrows the scope of liability, it reduces the number of successful cases, and thus the expected damages.

195. See supra text accompanying notes 172-74. In addition, corporate recovery also reduces the procedural costs inherent in derivative and class claims.

loss is increased by trebling the defendant’s potential liability in private, as well as public, suits, however, deterrence is increased correspondingly.197

The party contemplating suit must go through a similar analysis. If an individual plaintiff believes that expected recovery will be less than the cost of bringing suit, he is unlikely to enforce his rights against the defendant. The corporate plaintiff, on the other hand, is not as adversely affected by low expected recoveries. The corporation has many incentives to bring suit against persons trading on its confidential information in addition to monetary gains. To the extent the corporation seeks treble recovery in order to maintain high integrity and investor confidence, the potential for increased enforcement is improved.

In any event, the profits subject to trebling and restitution will be the full amount of actual profits made as a result of the illegal trade.198 The corporation is not suing for injury to itself, but rather to recoup the unjust benefit gained by the defendant. The corporation has been placed in this role to provide adequate enforcement of broad public goals and, as such, it is better to return full profits to the corporation than to allow the wrongdoer any gain from his behavior.199

4. Compensation for Investors

Compensation is important for investor confidence, buttressing notions of market integrity and fair play. Mere corporate recovery, however, fails to meet fully the investor protection goal of the federal securities laws as it does not necessarily protect or make whole the party injured by the defendant’s illegal activity.200 The corporate right of action for treble damages, although it provides increased relief, is not a solution to this dilemma; the funds available after treble recovery will generally be insufficient to compensate each individual investor fully.201

197. Fifitis Statement, supra note 67; cf. FED. SEC. CODE § 1708(b)(4) & comment 2 (Supp. II 1981) (giving courts discretion to increase the damage award up to 150% of the amount otherwise available "to provide a deterrent against [insider trading]").
198. Cf. the amount of investor recovery under this proposal, discussed infra in text accompanying note 203.
200. Indeed, in some cases corporate recovery will not benefit the injured party at all. Corporate plaintiffs, in suits against fraudulent buyers, no longer represent the injured investors. When the corporation receives the damage award, these investors, who now own no stock (or at least less stock) in the corporation, will be no better off. The wrongfully acting defendant, on the other hand, will be indirectly benefited by an increase in the assets of the corporation in which he now owns a share.
201. "The theory . . . is compensation if practical but in any event deterrence and avoidance of unjust enrichment." FED. SEC. CODE § 1711(j) comment 7(a) (Tent. Draft No. 2, 1978). Under this proposal, two-thirds of the corporate recovery will be available for injured investors. The corporation must hold this fund for a statutorily defined period of time from the date of judicial decision.
Nonetheless, treble corporate recovery subject to investor claims significantly advances the compensation goal of the federal securities laws.

Under the proposed statute, the corporation will hold two-thirds of any recovery subject to the superior claims of injured investors. Thus, some portion of the investor's loss can be compensated. Furthermore, recovery need not be based upon a current shareholder relationship with the corporation—all investors trading contemporaneously with the defendant are eligible for recovery.202 If a party has sold his shares to the defendant, he may recover a portion of the proceeds even though he is no longer a shareholder. Additionally, equity requires the defendant to dispose of his new holdings as part of his damage obligation, thus excluding him from indirect benefit in the corporation's increased value as a result of its recovery.

The proposal will limit the amount of each investor's claim to the losses incurred up to a reasonable time after public disclosure of the confidential information. Additional losses are excluded, since after reasonable time to allow the market to absorb the information and the investor to react, the investor can cover by either repurchasing or selling out his interest in the company.203

5. Investor Suits

The corporate cause of action proposed in this Comment is designed to supplement the existing scope of liability under Rule 10b-5 insider trading analysis. Thus, it does not preclude individual investors from seeking recovery under traditional fraud claims.204 Often, however, a...
relationship of trust or confidence between the parties, sufficient to support a fraud-based claim, will be absent. In these cases, the suit must be brought under the proposed corporate cause of action and the corporation will be the only party permitted to recover.

Exclusive use of the corporation as an instrument to effectuate greater enforcement of outsider trading may not always be effective, however. If the corporation is unwilling to sue, regardless of the incentives to do so, the investors will be without a remedy. Therefore, an investor-initiated suit should be available.

The investor's right to initiate suit on behalf of the corporation, while in many respects similar to a derivative right, is created by statute for the benefit of the corporation and its investors. This is of immediate benefit to injured investors. Shareholder derivative suits are generally regarded as clumsy and difficult enforcement mechanisms because of the procedural complications imposed by many federal and state statutes. A statutorily designed cause of action could bypass many of these obsta-

investors may have a private cause of action under Rule 10b-5. Under the proposed statute, therefore, a defendant may be held liable under two separate private causes of action for the same trading activity. In addition, under the Insider Trading Sanctions Act of 1984, see supra text accompanying notes 66-72, the SEC may obtain treble disgorgement of the defendant's profits.

Under this proposal, however, the defendant is not unduly burdened by these additional rights to recovery, nor are other investors in the corporation's shares. To the extent the individual plaintiff recovers, his recovery will offset the corporation's trebled judgment against the defendant (i.e., the payment to the individual plaintiff will not effect the defendant's profit, or losses avoided, for purposes of calculating his total obligation for wrongful trading). Furthermore, it will offset the individual plaintiff's pro rata recovery as shareholder in the subsequent distribution of the fund. The SEC's recovery will be subject to the corporation's superior claim on those funds, and will thus inure to the corporation.

205. This would be particularly true if members of the corporate management were implicated in the wrongdoing, or the corporation feared unfavorable publicity. See supra text accompanying notes 164-68.

206. The approach of both the corporate cause of action and the right of the investors to enforce that cause of action is similar to those currently available under § 16(b) of the Exchange Act, 15 U.S.C. § 78p(b) (1982). See supra note 28 and text accompanying notes 187-88; see also FED. SEC. CODE § 1714 (1980). Section 16(b) provides in pertinent part:

Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter . . .


208. See generally Bulbulia & Pinto, Statutory Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?, 53 NOTRE DAME L. 201 (1977) (listing and analyzing conflict of interests statutes); Buxbaum, Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions, 68 CALIF. L. REV. 1122 (1980). For examples of the federal and state derivative suit statutes, see FED. R. CIV. P. 23.1 (requiring demand on directors, contemporaneous ownership, and court approval for dismissal or compromise); CAL. CORP. CODE § 800 (Deering Supp. 1985) (requiring demand on directors, contemporaneous ownership, and security for expenses).
icles, however, avoiding "the difficulties of notice, proof of claim, apportionment, and distribution."209

Under this proposal, a member of the class of investors trading contemporaneously with the defendant will be able to make a demand on the corporation to sue. Current shareholder status will be unnecessary. The real party in interest for purposes of suit is the corporation; the investor plaintiff serves merely as the "vehicle for recovery."210 If the corporation refuses to bring suit, or fails to prosecute the suit diligently once it is brought, the investor has only the burden of showing that trading on inside information has occurred and a probability of success on the merits in order to maintain an action. Management conflicts of interests need not be proven and business judgment defenses will be unavailable. To accomplish this without undermining the preferred corporate suit, the statute will establish a waiting period during which the corporation has exclusive right to bring suit.211 After this period, the conflict of interest will be presumed.

CONCLUSION

Outside trading activity is detrimental to the integrity of the national securities markets. The SEC has recognized this and has stepped up enforcement efforts. Outside traders, however, often lack the necessary fiduciary status to bring them squarely within Rule 10b-5's proscriptions against manipulative and deceptive practices. Therefore, in order to curtail this activity, the SEC and the lower federal courts have developed new theories of liability. Unfortunately, as a result of the Supreme Court's fiduciary duty principle, many of these theories tend to distort the basic concepts of fraud and fiduciary duty analysis. The conflict between the different levels in the judicial system has made prosecution of insider trading violations difficult, expensive, and problematic.

The ALI and the securities bar have recognized the need for stronger enforcement of insider trading and have offered proposed solutions. Congress has gone one step further, enacting increased sanctions against abuse of confidential information. Nonetheless, these efforts do not adequately protect investors from the abuse of inside information by outside traders.

In light of the ultimate goals of the federal securities laws, there is no sound rationale for allowing an individual to trade on inside informa-

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209. Kajala, supra note 13, at 643.
211. Section 16(b) adopts "sixty days after request [for suit]" as an appropriate length of time. See supra note 206 and accompanying text.
tion to the detriment of others, regardless of the fiduciary relationship between them. Therefore, in order to appropriately deter abuses of confidential information, both the level of damages and the enforcement base should be increased. The corporate right of action proposed in this Comment implements these measures. It provides for private recovery of treble damages and adds an effective plaintiff to the enforcement base. Furthermore, because it is based upon fairness principles rather than fraud, it imposes economic disincentives upon a broader range of inside information abuses and improves the integrity of the securities markets.

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