UNITED STATES v. CARPENTER: SECOND CIRCUIT OVEREXTENDS THE MISAPPROPRIATION THEORY OF CRIMINAL LIABILITY UNDER RULE 10b-5

I. INTRODUCTION

The prohibitions against insider trading in the stock market are rooted in the general antifraud provisions contained in section 10(b) of the Securities and Exchange Act of 1934.[1] This area of the law has been vague and inconsistent because there is no explicit statutory definition of insider trading.[2] In order to delineate the parameters of section 10(b) and its counterpart, Rule 10b-5,[3] promulgated by the Securities and Exchange Commission (SEC),[4] the courts have

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1. 15 U.S.C. § 78 (1982). Section 10(b) of the 1934 Act provides in pertinent part:

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

15 U.S.C. § 78j. *See also* Phillips & Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65 (1984) [hereinafter Phillips & Zutz, *Repair*].

Insider trading may be explained in general terms as "trading in the securities markets while in possession of material information that is not available to the general public." Note, Dirks v. SEC: *Delineating the Scope of Insider Trading Liability Under Rule 10b-5*, 4 N. ILL. U.L. REV. 329 (1984) [hereinafter Note, *Delineating Scope*].

2. *See* Phillips & Zutz, *Repair*, *supra* note 1, at 72-73.

3. 17 C.F.R. § 240.10b-5 (1983). The rule states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. *See* Note, *The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters*, 38 STAN. L. REV. 1549, 1550 (1986) [hereinafter Note, *Inadequacy*]. The SEC is empowered by the 1934 Act to administer its provisions. "The [1934] Act assigns the SEC broad regulatory and rulemaking powers over the securities markets in

formulated definitions of "insider" and "inside information" on a case-by-case basis.[5] Judicial experimentation with theories upon which to premise liability for insider trading has confused the investing public about what actually is forbidden.[6] Adding to this confusion is the conflict between the Supreme Court's apparently restrictive construction of section 10(b) and Rule 10b-5 and the Second Circuit's broad interpretation.[7] The reason for the divergent rules seems to be based upon the weight accorded to various policy considerations.

The most recent pronouncement on the scope of insider trading came from the Second Circuit in *United States v. Carpenter*.[8] In *Carpenter*, the court employed the "misappropriation" theory to find that section 10(b) and Rule 10b-5 prohibited a *Wall Street Journal* employee from misappropriating a confidential publication schedule in connection with a scheme to purchase and sell securities.[9] The court held that a publication schedule revealing the timing and subject matter of future columns constituted inside information, and thus widened the scope of the prohibitions extensively.[10] According to one critic, the court's recognition that criminal liability for insider trading may be based upon a breach of an employer's confidentiality policy is an unwarranted interpretation of the policies underlying section 10(b) and Rule 10b-5.[11]

This comment will discuss the significance of the absence of a statutory definition of insider trading, the judicial interpretations of section 10(b) and Rule 10b-5 preceding the decision in *Carpenter*, and the reasoning employed by the court in *Carpenter*. It endorses the position of the dissenting opinion filed by Judge Miner, which stated that the *Carpenter* decision has gone too far by allowing the misappropriation theory of criminal liability for Rule 10b-5 to be dependent upon an employer's policy regarding information available to the employee during the course of his employment.[12]

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order to protect 'the interests of the public and investors against malpractices, in the securities and financial markets.' " *Id.*

5. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 2-4 (1982) [hereinafter Langevoort, *Fiduciary*].

6. *See id.* at 4.

7. *See* Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW. 1771 (1984) [hereinafter Farley, *Current*].

8. 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986).

9. *Id.* at 1026.

10. *Id.* at 1024. *See also* Obermaier, *Who's an Insider? What's Inside?*, N.Y.L.J., July 1, 1986, at 1, col. 1 [hereinafter Obermaier, *Inside*].

11. Obermaier, *Inside*, *supra* note 10, at 2, col. 3.

12. *Carpenter*, 791 F.2d at 1036 (Miner, J., dissenting).

II. STATUTORY BACKGROUND

A. *Development of Legislation on "Insider Trading"*

Section 10(b) of the 1934 Act serves as a general antifraud provision; it contains no express prohibition against insider trading.[13] In order to administer section 10(b), the SEC promulgated Rule 10b-5.[14] The SEC, however, like Congress, neglected to include a definition of insider trading,[15] causing confusion in the courts and uncertainty among market participants.[16] While in some cases the

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13. *See supra* note 1.

14. *See supra* note 4.

15. Liability for insider trading traditionally has been premised under § 10(b) and Rule 10b-5, even though § 16(b) of the 1934 Act explicitly regulates trading by insiders. This is because the scope of § 16(b) is extremely limited. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9 (1984) [hereinafter Macey, *Fairness*]. Section 16(b) states:

> (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. 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; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

15 U.S.C. § 78p(b).

Moreover, it should be noted that there are other sections of the 1934 Act and additional rules promulgated by the SEC which also touch upon insider trading. For example, § 14(e) of the 1934 Act, 15 U.S.C. § 7817(e) and its counterpart Rule 14(e)-3, 17 C.F.R. § 240.14e-3, are addressed to transactions in securities based upon material, nonpublic information in the context of tender offers.

16. *See* Farley, *Current*, *supra* note 7, at 1782; Langevoort, *Fiduciary*, *supra* note 5, at 3; Phillips & Zutz, *Repair*, *supra* note 1, at 72-73; Low, *Court Lets Broad Theory on Insiders Stand*, L.A. Daily, Apr. 29, 1985, at 3, col. 1 [hereinafter Low, *Stand*]; *Obermaier, Inside*, *supra* note 10, at 2, col. 4-5; Brodsky, *Some Clarifications Needed on Who is an Inside Trader*, N.Y.L.J., Apr. 28, 1983, at 1, col. 2 [hereinafter Brodsky, *Clarification*].

prohibitions of section 10(b) and Rule 10b-5 are clearly applicable,[17] in others the application is clearly without merit. The confusion produced by the large number of cases falling between the two extremes persuasively illustrates the need for a definition of insider trading.[18] Moreover, lack of legislative guidance on the subject of insider trading is responsible for the uncertainty in the law:

> The language of section 10(b) and Rule 10b-5 does not speak in terms of insider trading. Nor does the legislative history of section 10(b) give any indication, let alone guidelines, of what types of insider trading would be considered a manipulative or deceptive practice within the purview of this provision. In short, the breadth of section 10(b) and Rule 10b-5 and their ability to encompass insider trading are matched by their vagueness in defining what conduct

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17. Rule 10b-5 is clearly violated when "the president of a publicly traded company . . . learns at a board meeting of a major oil strike by his corporation and leaves the meeting to buy shares of the company stock before the news is made public." Brodsky, *Proposed "Insider Trading" Legislation: It has a Major Flaw*, L.A. Daily, May 11, 1983, at 4, col. 2 [hereinafter Brodsky, *Flaw*]. Rule 10b-5 is not implicated when a person purchases stock on the basis of information overheard in a conversation on the street about a corporate development, i.e., an acquisition, if he does not know who the participants are and has no relationship to the corporations involved. *Id. See also infra* notes 21-34 and accompanying text.

18. For cases dealing with the liability of nontraditional insiders under Rule 10b-5, see Dirks v. SEC, 463 U.S. 646 (1983) (securities analyst); Chiarella v. United States, 445 U.S. 222 (1980) (employee of financial printer); United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *cert. granted*, 107 S. Ct. 666 (1986) (reporters); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985) (employer of financial printer); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) (securities trader); Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979) (newspaper columnist recommending purchase of a corporation's stock); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787 (2d Cir. 1969) (acquisition partners), *cert. denied*, 400 U.S. 822 (1970); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (agents for an insider); and Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967) (employees, family, and friends of issuer). *See also* Glickman, *"Tippee" Liability Under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934*, 20 KAN. L. REV. 47 (1971); Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5 and Non-Traditional Insiders: The Supreme Court Continues its Entrenchment Trend*—Chiarella v. United States, 30 DEPAUL L. REV. 180 (1980) [hereinafter Note, *Rule 10b-5*]; Note, *Drawing the Line on Insiders and Outsiders for Rule 10b-5:* Chiarella v. United States, 4 HARV. J.L. PUB. POL'Y 203 (1981) [hereinafter Note, *Drawing*]; Note, *Delineating Scope*, *supra* note 1; Note, *Inadequacy*, *supra* note 4; Comment, *Inside Information and Outside Traders: Corporate Recovery of the Outsider's Unfair Gain*, 73 CALIF. L. REV. 483 (1985) [hereinafter Comment, *Inside Information*].

> is prohibited, a fact demonstrated in the judicial decisions that have shaped the insider trading doctrine.[19]

With virtually no guidance, the courts have tested various theories of insider trading liability.[20] Since section 10(b) and Rule 10b-5 are couched in terms of fraud, these judicially-developed theories must link fraudulent conduct and insider trading.[21] When confronted with cases involving the liability of nontraditional insiders such as securities analysts, reporters, and friends and relatives of issuers,[22] the court has "to go through mental gymnastics" to find fraud and, consequently, a violation of the Rule.[23] Thus, without a statutory definition of insider trading, adequate legislative history on the scope of section 10(b), or sufficient explanation from the SEC accompanying the promulgation of Rule 10b-5, "it should not be surprising that the contours of the law should be somewhat ill-defined."[24]

B. *The Lack of a Statutory Definition of Insider Trading—Some Pros and Cons*

Although both Congress and the SEC had watched the courts struggle with the application of Rule 10b-5, they were nonetheless opposed to the inclusion of a definition of insider trading in the Insider Trading Sanctions Act of 1984 (ITSA).[25] There are divergent

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19. Phillips & Zutz, *Repair, supra* note 1, at 73. *See also* Langevoort, *Fiduciary, supra* note 5, at 3; Note, *Securities—Insider Trading—The Personal Gain Test: The Supreme Court Creates a Bridge Between* Chiarella *and Fraudulent "Outsider Trading"*—Dirks v. Securities & Exchange Commission, 14 SETON HALL L. REV. 715, 716 (1984) [hereinafter Note, *Securities*].

20. *See* Macey, *Fairness, supra* note 15 (discusses fairness theory and business property theory).

21. *See* Phillips & Zutz, *Repair, supra* note 1, at 73.

22. *See infra* note 38 and accompanying text (discussing nontraditional insiders).

23. *See* Brodsky, *Flaw, supra* note 17, at 4, col. 2.

24. *See* Langevoort, *Fiduciary, supra* note 5, at 3.

25. Pub. L. No. 98-376, 98 Stat. 1264 (codified in scattered subsections of 15 U.S.C.A. § 78 (Supp. 1984)). Under ITSA, the SEC is empowered to:

> seek a civil penalty, not exceeding three times the profit gained or loss avoided, against any person who has violated any provision of the [1934] Act or the rules or regulations thereunder by purchasing or selling a security while in the possession of material nonpublic information and it imposes the same restrictions on aiders and abetters.

Subcommittee on Annual Review, *Federal Securities Regulation: Court Decisions*, 41 BUS. LAW. 982 (1986). *See generally* Junewitz, *Insider Trading Act is Needed, But Without*

views as to whether Congress should have incorporated a definition of insider trading into ITSA.[26]

An examination of several arguments proffered during the drafting of ITSA illustrates these views. "The argument in favor of a statutory definition is that current law is too unclear to permit the fair imposition of civil penalties and that it covers transactions that should not be subject to a civil penalty."[27] Although this argument was ultimately rejected by the Committee on Energy and Commerce and the definition excluded, it gathered much support and its proponents still advocate the necessity of a statutory definition.[28] Proponents believe that incorporating a definition of insider trading would not have weakened ITSA but rather would have strengthened it by eliminating the confusion in the judiciary and thus expediting the SEC's enforcement procedures.[29] In addition, "the vagueness of the law poses a threat to securities institutions and to the efficiency of market pricing."[30] On the other hand, opponents of including a

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Defining the Term, Nat'l L.J., Apr. 30, 1984, at 24, col. 1 [hereinafter Junewitz, *Insider*]; Brodsky, *Flaw, supra* note 17, at 4, col. 2 (criticizing lack of specific definition setting forth who will be liable under the bill).

26. *See* Brodsky, *Flaw, supra* note 17, at 4, col. 2 (urging Congress to clarify definition of insider trading and generally advocating inclusion of statutory definition). Brodsky proposed the following:

> Thus at a minimum I believe the following should be made clear in the statute and in the legislative history as to the concept:
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> (1) It is meant to include persons whom I denominate as primary sources, who are in the employ of the issuer, or its agents, or other fiduciaries, or in the employ of other entities or persons who have the capacity to affect the market price of the issuer, and who receive and wilfully act upon non-public information.
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> (2) It is meant to include those persons who receive non-public information from such primary sources, knowing that such information is material and non-public, and who wilfully act upon it (so-called "tippees").
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> (3) The term is not meant to include those who casually or inadvertently come into possession of the non-public information, who have no relationship, through blood, employment, or agency, with either the issuer, its agents or fiduciaries, or those who have the capacity to affect market price, and who act upon it.

Brodsky, *Clarification, supra* note 16, at 2, col. 3.

But see Junewitz, *Insider, supra* note 25, at 25, col. 1 ("The guts of the law [embodying insider trading] is crystal clear and requires no legislative clarification." *Id.*).

27. Junewitz, *Insider, supra* note 25, at 24, col. 1.

28. *See supra* note 16.

29. *See* Brodsky, *Flaw, supra* note 17, at 4, col. 2.

30. *Id.* The SEC has acknowledged the importance of the role played by securities analysts:

> The efficiency of market pricing is only possible in a well informed

definition[31] argued that inclusion of a definition would allow sophisticated defense lawyers to create loopholes for further fraudulent conduct.[32] In declining to include a definition, the Committee stated that a statutory definition would reduce flexibility and would probably create new ambiguities, "thereby increasing rather than limiting uncertainty."[33]

To say the scope of Rule 10b-5 is ambiguous is an understatement. A glance at the decisions rendered during the 1980s illustrates that the scope of the Rule is dependent upon which side of the seesaw is up. As one critic noted,

> The concept of what is "insider trading" is now so confused in the courts and in the public's mind that the strong deterrent effect of an action by the SEC under existing law is significantly diluted by a general misconception of what

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> marketplace. Securities analysts fulfill this function by actively seeking out corporate information on behalf of their clients. Analysts actively seek bits and pieces of corporate information not generally known to the market for the express purpose of analyzing information and informing their clients who, in turn, can be expected to trade on the basis of the market informations conveyed. The value to the entire market of these efforts cannot be gainsaid . . . the analyst's work rebounds to the benefit of all investors.

Id. See also Dirks, 463 U.S. at 658 ("Imposing a duty to disclose or abstain solely because a person knowingly receives nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market.")

31. *See* Brodsky, *Flaw*, *supra* note 17, at 4, col. 2 (John Dingell, Democrat of Michigan, who introduced the legislation, was adamantly opposed to the inclusion of a definition in ITSA). See also the deliberations of the American Law Institute and The American Bar Association Securities Law Committee in drafting the *Proposed* Federal Securities Code

> which concluded that hard-core insider trading could be vaguely defined in section 1603 but that all other types of questionable conduct involving illicit misappropriation of market and insider information must be left to the courts which must determine whether the particular conduct amounts to a "fraudulent act" or a misrepresentation under section 1602(a)(1).

R. HAMILTON, CORPORATIONS 124 (2d ed. 1985 Supp.) [hereinafter R. HAMILTON].

32. *See* Brodsky, *Flaw*, *supra* note 17, at 4, col. 2. *See also* R. HAMILTON, *supra* note 31, at 123 (Arnold S. Jacobs testified that "[a]s with any broad anti-fraud remedy, the fringes of what constitutes the prohibited act are occasionally fuzzy. This, however, does not justify placing a definition in the bill; unscrupulous traders would skirt around any definition constructed.").

Although potential future tactics of defense attorneys in response to proposed legislation should be a factor considered by the Committee in determining whether to include a definition, it is questionable whether it should override the important need for continuity and stability in the law of insider trading.

33. R. HAMILTON, *supra* note 31, at 123.

is actually proscribed and the resulting litigation and conflicting court interpretations.[34]

III. DEVELOPMENT OF COMMON LAW REGARDING THE CORPORATE "INSIDER"

Judicial definitions of an "insider" and the theories which support them have varied during the years since the promulgation of Rule 10b-5.[35] The definitions formulated in several landmark cases indicate that the scope of the Rule has ranged from almost all encompassing to extremely limited.

It is helpful, when reviewing the cases applying Rule 10b-5, to make two distinctions: first, between traditional insiders and nontraditional insiders and, second, between inside information and outside or market information.[36] The first distinction answers the question, "who is trading?" Traditional insiders are "those directors, officers, controlling shareholders of an issuing corporation who trade in their own company's securities."[37] Nontraditional insiders, on the other hand, include all those who trade with an informational advantage but who did not acquire their advantage through positions as directors, officers, or shareholders of the company.[38] The second distinction answers the question, "what type of information is being used to gain an advantage?" Inside information is defined as:

information which comes from within the corporation or

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34. Brodsky, *Clarification, supra* note 16, at 2, col. 1. The ambiguity surrounding the law of insider trading may have both positive and negative effects on the conduct of market participants. On one hand, market participants may act conservatively in trading on nonpublic information for fear that their conduct may inadvertently fall under the prohibitions against insider trading. On the other hand, market participants with access to inside information and who are planning to use such information to their advantage may consider that the ambiguity of the law reduces their likelihood of being caught.

35. For a discussion of the law prior to the promulgation of Rule 10b-5, see 5 A. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10(b)-5 §§ 1-4 (1986); A. BROMBERG & L. LOWENFELLS, SECURITIES FRAUD & COMMODITIES FRAUD § 2.7(a), at 55 (1967) [hereinafter BROMBERG & LOWENFELLS].

36. *See* Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979) [hereinafter Brudney, *Insiders*]. For an application of these distinctions to the case law, see the Appendix.

37. Note, *Drawing, supra* note 18, at 211.

38. *See id.* at 205-11.

> affects the price of corporate stock because of its reflection of a corporation's expected earnings or assets. Market information concerns transactions in a corporation's securities that will have an impact on their future price quite apart from expected changes in the corporation's earnings or assets.[39]

Early interpretations of Rule 10b-5 which dealt with traditional insiders and inside information "were expansive, indicating a broad-based approach to the protections of investors."[40] This broad-based approach was illustrated in several cases decided in the 1940s and 1950s which interpreted the scope of the Rule based on notions of fairness.[41] Although the courts had experimented with the application of Rule 10b-5 to traditional insiders and inside information, it was not until the seminal case, *In re Cady, Roberts*,[42] that the judiciary articulated a doctrine to deal with nontraditional insiders and inside information.

A. Cady, Roberts—*The Disclose or Abstain Doctrine*

In *Cady, Roberts*, information that Curtiss-Wright Corporation planned a dividend reduction was communicated by a director of Curtiss-Wright to a broker-dealer, who then sold both his own and his family's stock in Curtiss-Wright in anticipation of the significant drop in the value of the stock that would occur when the planned dividend reduction was made public.[43] The court formulated the

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39. Brudney, *Insiders*, *supra* note 36, at 329.

40. Note, *Securities*, *supra* note 19, at 716.

41. *See* Speed v. Trans Am, 99 F. Supp. 808 (D. Del 1951) (finding fraud under Rule 10b-5 where parent company offered to buy subsidiary's stock from minority shareholders without disclosing true inventory value of shares was greater than shown in annual report); Karden v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946) (holding that a private right of action is implied under Rule 10b-5). *See also* Farley, *Current*, *supra* note 7, at 1771-75 (focusing upon the importance of these cases in terms of federalizing corporate law); Macey, *Fairness*, *supra* note 15, at 13-19 (commenting upon the justification for insider trading liability under Rule 10b-5.).

42. 40 S.E.C. 907 (1961). *See also infra* notes 43-54 and accompanying text (discussing the disclose or abstain doctrine formulated by the court in *Cady, Roberts*).

43. *Cady, Roberts*, 40 S.E.C. at 908-09 (Curtiss-Wright Board had approved a dividend reduction from the original $6.25 per share per quarter to $3.75 per share).

disclose or abstain doctrine and applied it to nontraditional insiders to find that the broker-dealer had violated Rule 10b-5.[44]

The disclose or abstain doctrine rests upon two principal elements:

> [The] first [is] the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose, and not for the personal benefit of anyone; and [the] second [is] the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[45]

These two elements give rise to the duty of a traditional insider to disclose to the public any material inside information he possesses or, if he is unable to disclose it, to abstain from trading upon this information.[46] By trading upon nonpublic information without disclosing it to the public, the insider violates Rule 10b-5.[47]

After formulating the doctrine, the court searched for a way to apply it to nontraditional insiders. The court focused upon the relationships between traditional insiders and those with whom they share their information. The insider, by transmitting information to various persons "who are in [a] special relationship with a company and in privy to its internal affairs,"[48] transmits to them the same duty to disclose or abstain by which he is bound. Thus, the court held that the director, a traditional insider subject to the disclose or abstain doctrine, had transmitted to the broker-dealer, a non-traditional insider, not only the information about the dividend reduction but also the obligation to disclose or abstain.[49]

B. *Expansion of the* Cady, Roberts *Approach and the Beginning of the Focus Upon Equal Access to Information*

Cady, Roberts represents a broad, flexible application of Rule

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44. *Id.* at 912 (court noted the fact that it had charged broker-dealers with the duty to disclose in analogous cases).

45. *Id.*

46. *Id.* at 911.

47. *Id.* (those traditionally recognized as corporate insiders include officers, directors, and controlling stockholders).

48. *Id.* at 912 (examining "special relationship" court noted that "intimacy demands restraint lest the uninformed be exploited").

49. *Id.*

10b-5,[50] which the court in *SEC v. Texas Gulf Sulphur*[51] endorsed and expanded. In *Texas Gulf Sulphur*, the Court of Appeals for the Second Circuit "fully embraced the fairness concept as the proper theoretical basis for assigning liability under Rule 10b-5."[52] By reaffirming the disclose or abstain doctrine set forth in *Cady, Roberts* and extending it "to anyone in possession of material inside information,"[53] the court in *Texas Gulf Sulphur* widened the scope of Rule 10b-5 significantly. The court justified its expansive holding by stating that market participants have an expectation that they are trading in a securities marketplace where all investors have relatively equal access to material information.[54]

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50. Although the disclose or abstain doctrine in itself represented a broad application of Rule 10b-5, there were divergent views regarding the circumstances in which the doctrine arose. Most courts interpreted the doctrine in its broadest sense, requiring the duty to disclose or abstain based upon possession of information. *See* SEC v. Great Am. Indus., Inc., 407 F.2d 453 (2d Cir. 1968), *cert. denied*, 395 U.S. 290 (1969); General Time Corp. v. Talley Indus., Inc., 403 F.2d 159 (2d Cir. 1967), *cert. denied*, 393 U.S. 1026 (1969). However, there were some courts which required the duty to be premised upon the existence of a fiduciary relationship. *See* Coates v. SEC, 394 U.S. 979 (1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971). *See generally* Note, *Securities*, *supra* note 19, at 724 (courts split as to whether fiduciary relationship is required to trigger disclose or abstain doctrine).

51. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971). Certain officers, directors, and employees of Texas Gulf Sulphur (TGS) were charged with violating § 10(b) and Rule 10b-5 because they had purchased TGS stock on the basis of information concerning TGS' extensive ore discovery which had not yet been made public. *Id.* In response to rumors that TGS had made a substantial discovery, TGS officers issued a press release on April 12, 1964, which stated that "the work done to date has not been sufficient to reach definite conclusions, and any statement as to size and grade of ore would be premature and possibly misleading." *Id.* at 845. As the drilling activity neared completion around April 13, 1964, a reporter prepared an article which confirmed a 10 million ton ore strike. *Id.* This article was published on April 16, 1964, in a Canadian mining industry journal. *Id.* On the same day, an official statement was read to representatives of the American financial media announcing a strike of at least 25 million tons. *Id.* Between the time of the first press release on April 12 and the official announcement on April 16, TGS insiders engaged in market activity. *Id.* at 847.

52. Macey, *Fairness*, *supra* note 15, at 17.

53. *Texas Gulf Sulphur*, 401 F.2d at 848. The court stated:

> the Rule [the disclose and abstain doctrine] is also applicable to one possessing the information who may not be strictly termed an "insider" . . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed.

Id.

54. *Id.*

In addition to expanding the definition of a traditional insider, the court examined and clarified the definition of inside information.[55] Since the information traded upon came from within the corporation, it clearly fell within the definition of inside information, and the court did not focus on the difference between inside information and market information. Instead, the court concentrated upon the materiality of the information.[56] The court stated that to determine materiality, one looks to whether a reasonable man would consider the information to be important in reaching a decision concerning a particular transaction.[57] Materiality should be determined by "a balancing of both the intended probability that the event will occur, and the anticipated magnitude of the event in light of the totality of the company activity."[58] The court's broad definition of materiality is consistent with its expansive definition of an insider.[59] The effect of *Texas Gulf Sulphur* was to change the judiciary's focus from fiduciary duties to the notion that it is inherently unfair to allow informational advantages among market participants.[60]

The Second Circuit again emphasized the necessity of equal access to material information in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*[61] *Shapiro* held that the disclose or abstain doctrine as

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55. *Id.* at 849.

56. *Id.* The court stated "that material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities." *Id.*

57. *Id.*

58. *Id.*

59. *Id.* (court rejected the premise suggested by the trial court that the "test [of materiality] must necessarily be a conservative one"). *Id. But see* Note, *Delineating Scope*, *supra* note 1, at 338 (suggesting that the finding of materiality serves as a limitation on the all-encompassing theory set forth in *Texas Gulf Sulphur*).

60. *See* Farley, *Current*, *supra* note 7, at 1773.

61. 495 F.2d 228 (2d Cir. 1974). In *Shapiro*, a plaintiff class composed of purchasers of stock of Douglas Aircraft Corporation brought an action under Rule 10b-5 to recover damages from Merrill Lynch and its officers, directors, and employees for disclosing nonpublic information to Merrill Lynch's clients concerning the value of the Douglas stock. *Id.* at 231-32. Merrill Lynch had been engaged as the underwriter for a Douglas debenture offering. *Id.* at 231. Merrill Lynch, through its position as underwriter, acquired adverse inside information regarding Douglas' earnings. *Id.* at 232. Merrill Lynch disseminated this confidential information to its clients, who sold their stock in Douglas. *Id.* Plaintiffs purchased shares of stock without the benefit of any inside information, and when Douglas common stock suddenly dropped in value, they sustained losses. *Id.* at 233. Although Merrill Lynch moved for judgment on the pleadings, it was denied by the trial court and affirmed by the court of appeals. *Id.* at 228.

See also In re Investors, 44 S.E.C. 633 (1971) (SEC dispensed with concepts of

enunciated in *Texas Gulf Sulphur* applied in a private damage action, because the policy justifications for imposing the doctrine set forth in *Texas Gulf Sulphur* (an SEC injunctive action) were equally applicable to both cases.[62] The court then addressed the liability of both nontrading "tippers" and trading "tippees" under section 10(b) and Rule 10b-5.[63] The court extended the duty of the nontrading tippers (in this case brokers) to either disclose or abstain, beyond the actual informed stock purchasers, to include uninformed purchasers as well.[64] The tippers thus owed a duty to *all* purchasers who bought stock during the period that the nontrading tippers (brokers) had sold the affected stock to the informed purchasers.[65] Citing *Texas Gulf Sulphur*, the court also imposed the disclose or abstain doctrine upon the trading tippees.[66]

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fiduciary duty and focused upon the unfairness that results when one person is in possession of material nonpublic information which places him in a position "superior to other investors"). *But see id.* at 648 (concurring opinion) (warning against the focus upon and extension of the equal information standard).

62. *Shapiro*, 495 F.2d at 236. The court stated,

> In short, whether invoked in an SEC injunction action or in a private damage action, "the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . . Since one of the primary goals of the antifraud provisions of the securities laws would be frustrated if our 'disclose or abstain' rule enunciated in Texas Gulf were to be limited to SEC injunction actions and held inapplicable to private damage actions, we reject such ground of distinction."

Id.

63. *Id.* at 237-38. A tippee receives inside information from an insider who is acting in a capacity other than his business capacity. BROMBERG & LOWENFELLS, *supra* note 35, at § 7.5(2).

64. *Shapiro*, 495 F.2d at 237.

65. *Id.*

66. *Id.* In *Texas Gulf Sulphur*, although the issue of tippee liability was not before it, the court stated, in *dicta*:

> As [the] "tippees" are not defendants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the [disclose or abstain doctrine] as the conduct of their inside source, though we note that it certainly could be equally reprehensible.

Texas Gulf Sulphur Co., 401 F.2d at 852-53. For other cases dealing with tippee liability, see, e.g., SEC v. Dirks, 463 U.S. 646 (1983) (former insurance company employee tips securities analyst who tips his clients); United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. denied*, 107 S. Ct. 666 (1986) (reporter tips stockbroker); SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (office manager in law firm tipped nonpublic information to bond traders); Ross v. Licht, 263 F. Supp. 395 (S.D.N.Y. 1967) (court distinguished insiders from tippees but nonetheless held that tippees were subject to the disclose or abstain doctrine).

This expansive approach to Rule 10b-5 was illustrated in several other cases[67] before *Blue Chip Stamps v. Manor Drug Stores*[68] put a halt to the liberal interpretation of the Rule's applicability to nontraditional insiders.[69]

C. Blue Chip *Leads Move to Restrictive Application of Section 10(b) and Rule 10b-5*

In *Blue Chip*, the Supreme Court narrowly applied Rule 10b-5 to offerees of a stock offering made pursuant to an antitrust consent decree. It held that the offerees could not maintain a Rule 10b-5 action against the offeror because they were not purchasers or sellers of securities as those terms are defined under the 1934 Act.[70] The Court repeatedly cited *Birnbaum v. Newport Steel Corp.*[71] to support its

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67. *See, e.g.*, Superintendent of Ins. v. Bankers Life & Co., 404 U.S. 6, 12 (1971) (Court stated that § 10(b) is not "limited to preserving the integrity of the securities markets . . . . Section 10(b) must be read flexibly, not technically and restrictively."); SEC v. Capital Gains Research Bureau, 375 U.S. 180, 185-86 (1963) (Court stated that Congress intended the antifraud provisions found in the 1934 Act to be construed not technically and restrictively, but flexibly to effectuate its remedial purposes).

68. 421 U.S. 723 (1974), *reh'g denied*, 423 U.S. 884 (1975). The facts in *Blue Chip* may be summarized as follows: The United States in 1963 filed a civil antitrust action against Blue Chip Stamp Co. and nine retailers who held 90% of its shares. *Id.* at 725. Four years later, a consent decree, which contemplated a reorganization under which Old Blue Chip was to merge into Blue Chip Stamps (New Blue Chip), terminated the action. *Id.* at 725-26. Under the reorganization plan, New Blue Chip was to offer some of its shares of common stock to customers but not to shareholders of Old Blue Chip. *Id.* at 726. The offering was launched and a prospectus distributed to the offerees. *Id.* Plaintiff was one of the offerees and filed suit two years later against defendants, Old and New Blue Chip Companies, several shareholders of Old Blue Chip and the directors of New Blue Chip, claiming that the prospectus was materially misleading. *Id.* They contended that the prospectus was made overly pessimistic so that offerees would reject the shares and Blue Chip could later offer these shares to the public at a higher price. *Id.* at 726-27. The district court dismissed the complaint and the plaintiff appealed. *Id.* at 727. The court of appeals reversed and remanded. *Id. Certiorari* was granted and the Supreme Court reversed the judgment of the court of appeals. *Id.*

69. *See* Note, *Rule 10b-5*, *supra* note 18, at 189.

70. *Blue Chip*, 421 U.S. at 731.

71. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). In *Birnbaum*, the court noted that both § 10(b) and Rule 10b-5 proscribed only fraud in connection with the purchase or sale of securities and that there was no legislative intent in the history of § 10(b) that indicated a private damage action should be extended to persons other than purchasers and sellers of securities. *Id.* at 463-64. The court contrasted the language and history of the general antifraud provision in § 10(b) against the explicit granting of a civil remedy provided in § 16(b) of the 1934 Act and concluded that a private right of action under Rule 10b-5 should be limited

decision to limit those persons entitled to seek damages under Rule 10b-5 and also emphasized the advantages of restricting the scope of the Rule.[72] For example, the Court stated that restricting the scope of Rule 10b-5 would reduce the "danger of vexatious litigation."[73] The Court feared that expanding the scope of Rule 10b-5 to allow persons other than defrauded purchasers and sellers to seek damages would be akin to opening Pandora's box.[74] Moreover, after examining the subsequent legislative history of the 1934 Act, the Court concluded that Congress' rejection of proposed amendments to broaden section 10(b) illustrated a desire for a restricted scope.[75]

Cases following *Blue Chip* illustrate further attempts to restrict

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to actual purchasers and sellers. *Id.* at 464. Limiting the class of persons entitled to bring a private damage action under Rule 10b-5 to only those actual purchasers and sellers has been referred to as the *Birnbaum* rule.

72. *Blue Chip*, 421 U.S. at 738-41. The court also discussed the major disadvantages which accompanied the *Birnbaum* rule. "The *Birnbaum* limitation . . . is an arbitrary restriction which unreasonably prevents some deserving plaintiffs from recovering damages which have in effect been caused by violations of Rule 10b-5." *Blue Chip*, 421 U.S. at 738. *See also* Lowenfells, *The Demise of the* Birnbaum *Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268 (1968) (discussing and analyzing the demise of *Birnbaum* Rule).

73. *Blue Chip*, 421 U.S. at 740. The court was concerned with the possibility of "vexatious litigation":

> The first of these concerns was that in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial so long as he may prevent the suit from being resolved against him by dismissal or summary judgment.

Id. "Moreover, . . . with respect to discovery, to 'permit plaintiff[s] with . . . largely, groundless claim[s] to simply take up the time of a number of other people . . . it is societal cost rather than a benefit.'" *Id.* at 741. The court's second ground of concern was that, "given the generalized contours of liability, the abolition of the *Birnbaum* rule would throw open to the trier of fact many rather hazy issues of historical fact the proof of which is dependent almost entirely on oral testimony." *Id.* at 743.

74. *Id.* at 747-48.

75. *Id.* at 732. The court noted:

> In 1957 and again in 1959, the Securities and Exchange Commission sought from Congress amendment of § 10(b) to change its wording from "in connection with the purchase or sale of any security" to "in connection with the purchase or sale of, or in any attempt to purchase or sell any security" . . . [T]he purpose of the proposed change was "to make section 10(b) also applicable to manipulative activities in connection with any attempt to purchase or sell any security" . . . . Opposition to the amendment was based on fears of the extension of civil liability under §10(b) that it would cause."

Id. at 732 (citations omitted).

the application of section 10(b) and Rule 10b-5 by the Court's strict scrutiny of the Rule's elements.[76] For example, in *Ernst & Ernst v. Hochfelder*,[77] the Court held that a private damage action would not be permitted under section 10(b) and Rule 10b-5, absent an allegation of "scienter,"[78] defined as the intent to deceive, manipulate, or defraud.[79] As in *Blue Chip*, the Court analyzed the language of section 10(b) in reaching its decision to restrict the scope of the Rule. In *Blue Chip* the scope of the Rule was restricted by limiting the class of persons who have standing under Rule 10b-5. In *Hochfelder* the scope was narrowed by disallowing private damage actions under section 10(b) which are premised on mere negligent conduct. Noting Congress' use of the words "manipulative," "device," and "contrivance" in section 10(b), the Court found an indication of intent to proscribe conduct that was more egregious than mere negligence.[80]

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76. *See* Note, *Rule 10b-5*, *supra* note 18, at 189. *See, e.g.*, Aaron v. SEC, 446 U.S. 680, 691 (1980) ("rationale of *Hochfelder* ineluctably leads to the conclusion that scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought"); Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, *reh'g denied*, 430 U.S. 976 (1977) (tender offeror suing in its capacity as a takeover bidder did not have standing to sue for damages under § 14(e)); Sante Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) (when based only upon instances of corporate mismanagement, shareholder's allegations of unfair treatment by a fiduciary are not within scope of the statute or rule). *See generally* Froliech & Speigal, *Standing of Federal Securities Plaintiffs—Which Way the Trend*, 24 DEPAUL L. REV. 510 (1975) (examining question of proper party to seek recovery under § 10(b) and Rule 10b-5); Whitaker & Rotch, *The Supreme Court and the Counter Revolution in Securities Regulation*, 30 ALA. L. REV. 335 (1979) (discussing United States Supreme Court cases making plaintiff's survival of a motion to dismiss in a securities regulation action more difficult).

77. 425 U.S. 185, *reh'g denied*, 425 U.S. 986 (1976). In *Hochfelder*, Ernst & Ernst, an accounting firm, was retained by First Securities Company of Chicago, a brokerage firm to audit its books and records. *Id.* at 188. Customers of First Securities invested in a fraudulent securities scheme perpetuated by the president and majority shareholder of First Securities. *Id.* at 189. Upon discovering that they had been defrauded, the customers filed an action against First Securities, its president, and Ernst & Ernst under § 10(b). *Id.* It alleged that First Securities and its president had violated Rule 10b-5 and that Ernst & Ernst had aided and abetted in the violations because it had not conducted thorough audits. *Id.* at 190. The customers contended that had the audits been conducted properly, the fraudulent securities scheme would have been uncovered. *Id.* The district court granted Ernst & Ernst's motion for summary judgment; however, the court of appeals reversed and remanded. *Id.* at 191.

78. *Id.* at 201.

79. *Id.* at 193.

80. *Id.* at 201. The Supreme Court refuted the SEC's argument (presented in an *amicus curiae* brief) which stated that although the language in § 10(b) refers to use of any "manipulative or deceptive device or contrivance," it did not necessarily

In addition, an analysis of the legislative history of the 1934 Act provided the Court with additional guidance and supported its interpretation of the language of section 10(b).[81]

The conservative construction of section 10(b) and Rule 10b-5 adopted in *Blue Chip* continued into the 1980s, as illustrated by *Chiarella v. United States*.[82] Although consistent with the Supreme Court's attempt to confine the scope of the Rule, *Chiarella* also marks the beginning of the modern trend, whereby the scope of Rule 10b-5 becomes dependent upon which policies the court considers most important.

IV. THE MODERN TREND: WHO IS AN INSIDER AND WHAT CONSTITUTES INSIDE INFORMATION IN THE 1980S?

Judicial interpretations of the scope of Rule 10b-5 have varied dramatically in the 1980s. A comparison of Supreme Court and Second Circuit decisions illustrate an inconsistency. The Supreme Court's continued attempts to restrict the Rule's application are matched by the Second Circuit's determined efforts to widen it.[83]

A. Chiarella *Lays the Foundation for the Misappropriation Theory*

The modern trend began with *Chiarella*, in which the Supreme Court held that a duty to disclose does not arise from mere possession of nonpublic information.[84] Chiarella, a markup man employed by

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preclude application of § 10(b) to conduct other than intentional practices. The SEC also reasoned that since the effect upon investors was the same whether the conduct is a product of intent or negligence, the Congressional intent behind the formulation of § 10(b) must have been to include all types of conduct. Rejecting this argument and the position of the SEC, the Court stated: "[I]n view of the language, which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its content, further inquiry may be unnecessary." *Id.*

81. *Id.* at 201-06. The Court noted that although "neither the intended scope of § 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history of the 1934 Act . . . [t]here is no indication . . . that §10(b) was intended to proscribe conduct not involving scienter." *Id.* at 202. Moreover, section 10(b) was described by Thomas G. Corcoran, a spokesman for the drafters of the 1934 Act, as a "catch-all clause to prevent manipulative devices." *Id.* The Court doubted that any "lawyer, draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions." *Id.* at 203.

82. 445 U.S. 222 (1980).

83. *See* Comment, *Inside Information*, *supra* note 18, at 485.

84. *Chiarella*, 445 U.S. at 233.

a financial printer, had traded in the market based upon information he had gathered during the course of his employment.[85] Chiarella worked with confidential documents which often contained information about proposed takeovers. Although the confidential documents did not disclose the names of either the acquiring or target companies, Chiarella deduced that information himself, purchased shares of the target companies, and later sold them after the takeover attempts were made public.[86] The Supreme Court concluded that Chiarella's conduct did not constitute a violation of Rule 10b-5.[87] The Court reversed the court of appeals' decision upholding Chiarella's conviction and rejected an expansive interpretation of section 10(b).[88] It noted that neither the language nor the legislative history of section 10(b) indicated congressional intent to create a general duty among market participants to abstain from trading based on nonpublic information absent a specific relationship between two parties creating such a duty.[89]

The Supreme Court's endorsement of a restricted scope of the Rule was the result of its return to a "rigorous statutory analysis in which misrepresentation, fraud, and deception were deemed the targets of the legislation and, therefore the polestar of judicial construction and interpretation."[90] Its enhanced scrutiny of section 10(b) led the Court to conclude that silence may be actionable under section 10(b) only where there exists a duty to disclose arising from

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85. *Id.* at 224.

86. *Id.*

87. *Id.* at 222.

88. *Id.* at 225. The Court of Appeals for the Second Circuit espoused a broad theory of liability under Rule 10b-5. It affirmed Chiarella's conviction by holding that "anyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose." United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). It noted, furthermore, that this "regular access to market information" test would create a workable rule embracing "those who occupy . . . strategic places in the market mechanism." *Id. See also* Phillips & Zutz, *Repair, supra* note 1, at 77-78 (referring to theory espoused by court of appeals in *Chiarella* as the "possession theory").

89. *Chiarella*, 445 U.S. at 233. The court stated that:

> formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between the two parties . . . should not be undertaken absent some explicit evidence of congressional intent. As we have seen, no such evidence emerges from the language or legislative history of § 10(b).

Id.

90. Farley, *Current, supra* note 7, at 1775.

a fiduciary relationship.[91] The Court held that Chiarella had no such relationship "with the sellers of the target company's securities" because he was a complete stranger to them.[92] The Court thus declined to impose liability on a nontraditional insider who acquired and employed market information for personal gain in the market place.

The Supreme Court succinctly stated its adamant opposition to a broad interpretation of section 10(b): "Section 10(b) is aptly described as a catch-all provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."[93] Despite its narrow interpretation of section 10(b), the majority opinion left open the question of whether an employee's misappropriation of information from his employer may constitute a breach of a fiduciary duty and ultimately a violation of section 10(b).[94] The Court did not address this question because the misappropriation theory of criminal liability was not submitted to the jury.[95] However, in a dissenting opinion, Chief Justice Burger urged a broad interpretation which foreshadowed an affirmative response to the question. Pointing out that the repeated use of the word "any" in section 10(b) and Rule 10b-5 indicates obvious intent for comprehensive application, he argued that the jury instructions given by the district court were sufficient to have enabled the jury to premise Chiarella's liability on a misappropriation theory.[96] He stated that "[t]he Court's reading of the District Court's

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91. *Chiarella*, 445 U.S. at 230. The court felt that:

> administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . . [However] such liability [must be] premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.

Id.

92. *Id.* at 232-33. Chiarella had no prior dealings with the sellers of the target company's securities. *Id.* at 232. "He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence." *Id.*

93. *Id.* at 234-35.

94. *Id.* at 236.

95. *Id.*

96. *Id.* at 241 (Burger, C.J., dissenting). The jury instructions given by the district court stated in part:

> In simple terms, the charge is that Chiarella wrongfully took advantage of information he acquired in the course of his confidential position at Pandick Press and secretly used that information when he knew other people trading in the securities market did not have access to the same

charge is unduly restrictive. Fairly read as a whole and in the context of the trial, the instructions required the jury to find that Chiarella obtained his trading advantage by misappropriating the property of his employer's customers."[97]

B. *Application of the Misappropriation Theory by the Second Circuit*

Chief Justice Burger's dissent in *Chiarella* presaged the decision in *United States v. Newman*[98] which employed the misappropriation theory.[99] The theory is "that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[100] By analyzing the Rule 10b-5 language systematically, the Second Circuit explained how Newman's conduct violated the Rule.[101] Newman, a securities trader,

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> information that he had at a time when he knew that that information was material to the value of the stock.

Id. at 243-44.

97. *Id. See generally* Note, *Rule 10b-5*, *supra* note 18, at 193 (criticizing majority holding in *Chiarella*).

> The purpose of the federal securities laws is to create a securities market which provides reliable information for investors and prevents investors from being harmed by those with trading advantages. Because Chiarella's acts apparently struck at the very center of the infractions the securities laws were designed to prevent, the Supreme Court's reversal of his conviction stands in contrast to legislative expectations of the protective function of the 1934 Act.

Id.

98. 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983).

99. *But see* Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 115-17 (1984) (suggesting that Chief Justice Burger's dissenting opinion did not form the basis for the misappropriation theory adopted by the Second Circuit in *Newman*).

100. *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

101. *Newman*, 664 F.2d at 17. The court systematically applied each element of the Rule to Newman's conduct. First, the court noted that Newman's conduct satisfied the element of fraud. It quoted Chief Justice Burger's dissent in *Chiarella*, which stated that "the defendant misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost of confidence." *Id.* The court noted that Newman,"[b]y sullying the reputations of Courtois' and Antoniu's employers as safe repositories of client confidences, appellee [Newman] and his cohorts defrauded those employers as surely as if they took their money." *Id.*

Second, the requirement that the fraud or deceit be perpetrated upon "any person" was met, first, because, as noted above, Newman had sullied the reputations of both Morgan Stanley and Kuhn Loeb and, further, because Newman's conduct was detrimental to the clients of the aforementioned firms "whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information." *Id.*

Third, the court focused upon the language in the Rule requiring that the

received information about merger and takeover targets from Courtois, an employee of Morgan Stanley & Co., Inc. and Antoniu, an employee of Kuhn Loeb & Co.[102] Newman passed this information along to two co-conspirators.[103] Together, they purchased stock in the companies which were merger and takeover targets of Morgan Stanley and Kuhn Loeb.[104] Newman, like Chiarella, was a nontraditional insider who obtained market information. However, Newman's conduct, unlike Chiarella's, was held to violate Rule 10b-5.[105] Although both the *Chiarella* and *Newman* cases involved nontraditional insiders who misappropriated market information, their outcomes were different owing largely to the policy considerations deemed paramount by the Supreme Court on one hand, and the Second Circuit on the other.[106]

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fraud or deceit be "in connection with the purchase or sale of any security." Citing prior case law, the court supported its position that the phrase "in connection with" is to be construed "flexibly to include deceptive practices" touching "the sale of securities." *Id.* at 18. With this construction in mind, the court concluded that "since appellee's [Newman's] sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies, we find little merit in his disavowal of a connection between fraud and the purchase." *Id.*

102. *Id.* at 15-16.

103. The indictment contained charges of securities fraud, mail fraud, and conspiracy.

> The indictment charges that Courtois and Antoniu breached the trust and confidence placed in them and their employers by the employers' corporate clients, and the clients' shareholders, and the trust and confidence placed in Courtois and Antoniu by their employers. The indictment charges further that Newman, Carniol and Spyropoulos [the later two referred to in the text as co-conspirators] aided, participated in, and facilitated Courtois and Antoniu in violating the fiduciary duties of honesty, loyalty and silence owed directly to Morgan Stanley, Kuhn Loeb, and clients of those investment banks.

The indictment also charges that Courtois, Newman and Carniol

> did directly, and indirectly (a) employ devices, schemes, and artifices to defraud and (b) engage in acts, practices, and courses of business which operated as a fraud and deceit on Morgan Stanley, Kuhn Loeb, and those corporations and shareholders on whose behalf Morgan Stanley or Kuhn Loeb was acting, and to whom Morgan Stanley or Kuhn Loeb owed fiduciary duties in connection with the purchase of securities.

Id.

104. *Id.* at 15.

105. Note, *Rule 10b-5*, *supra* note 18, at 195. Chiarella's conduct was not a violation of Rule 10b-5 because the Supreme Court "couch[ed] its analysis solely in terms of traditional insiders. [T]he Court failed to acknowledge that the SEC had instructed in *Cady, Roberts*, that liability for section 10(b) violations is not limited to those occupying traditional insider positions." *Id.*

106. *Chiarella*, 445 U.S. at 233. In *Chiarella*, the Supreme Court's decision

C. *Supreme Court Endorses a Restrictive Approach to Tipper and Tippee Liability Under Rule 10b-5.*

The Supreme Court tightened the reins on the scope of Rule 10b-5 in *Dirks v. SEC*[107] by holding that a tippee assumes a fiduciary duty not to trade on material nonpublic information *only* when the insider (tipper) has breached his duty to the shareholders *and* "the tippee knows or should know that there has been a breach."[108] To determine whether the insider's tip constituted a breach of fiduciary duty, the Court looked to whether the insider had personally benefited from his disclosure.[109] Dirks, an officer of a broker-dealer firm, provided investment analysis of insurance company securities to investors. He received information from a former officer of Equity Funding Corporation of America, an insurance company, that Equity Funding's assets were overstated as a result of fraudulent corporate practices.[110] Dirks' informant urged him to verify and disclose this fraud. Dirks investigated the informant's allegations and concluded that they were true. He voluntarily presented the information he had gathered to the SEC in order to direct the SEC's attention to Equity Funding's wrongdoing.[111] During the course of his investigation, he discussed his findings with several of his clients, who in turn sold

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appeared to be motivated by the perceived dangerous consequences that would result if Chiarella were convicted under Rule 10b-5. "We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material nonpublic information." *Id.*

The Second Circuit in *Newman*, on the other hand, recognized that the 1934 Act had a broader purpose than just the protection of investors. Ironically, quoting the Supreme Court in United States v. Natfalin, 441 U.S. 768 (1979), the Second Circuit noted that "neither . . . Court nor Congress . . . suggested that protection was the sole purpose of the Act . . . [A] 'key part' of that program [evidenced by enactment of the federal securities statutes] was the effort to achieve a high standard of business ethics . . . in every facet of the securities industries." *Id.* at 775.

107. 463 U.S. 646 (1983).

108. *Id.* at 660.

109. *Id.* at 662. The court stated, "[C]ourts [must] focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* at 663.

See also Brudney, *Insiders, supra* note 36, at 348 (theory is that the insider is in effect selling the information to its recipient for cash, reciprocal information, or other things of value to himself). *But see Dirks*, 463 U.S. at 663 (argument made by SEC opposing the requirement of the personal benefit test in the law regarding tippee liability).

110. *Dirks*, 463 U.S. at 649.

111. *Id.* at 650 (Dirks voluntarily presented his information to the SEC's regional office beginning on March 27, 1973).

their holdings.[112] The price of Equity Funding's stock dropped significantly and trading was halted by the New York Stock Exchange.[113] After state insurance authorities uncovered evidence of the fraud, the SEC filed a complaint against Equity Funding. At a hearing concerning Dirks' role in exposing the fraud, the SEC concluded that Dirks had aided and abetted in violation of section 10(b) and Rule 10b-5.[114] On appeal, the court of appeals entered judgment against him.[115]

Reversing, the Supreme Court recognized the important role of securities analysts in enhancing market efficiency and acted to protect them from "the potential dangers of uncertain liability under the securities laws."[116] Rejecting the SEC's broad theory of tippee liability,[117] the Court stated that imposing a disclose or abstain duty on individuals who merely received information from an insider and then traded upon it might inhibit the "preservation of a healthy market."[118] However, Justice Blackman's well-reasoned dissent ar-

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112. *Id.* at 649.

113. *Id.* at 650 (price of Equity Funding stock fell from $26 per share to less than $15 per share).

114. *Id.* at 650-51. The SEC concluded: "Where 'tippees'—regardless of their motiviation or occupation come into possession of material 'corporate information that they know is confidential or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading." *Id.* at 650.

115. *Id.* at 652.

116. Farley, *Current, supra* note 7, at 1778.

117. *Dirks*, 463 U.S. at 655-56. The SEC's position, as stated in its opinion in this case, is that a tippee "inherits the *Cady, Roberts* obligation to shareholders whenever he receives inside information from an insider . . . . Such a tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof." *Id.*

118. *Id.* at 658. The Court also stated:

> It is commonplace for analysts to "ferret out and analyze information," 32 S.E.C. Docket, at 1406, and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

Id. at 658-59.

In addition, although the SEC urged the Court to adopt a broad theory of liability, it too recognized the importance of analysts' function in the marketplace. The SEC expressly recognized that "[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by

gued that the majority's personal benefit test rested upon the policy that the ends justify the means.[119] The benefits conferred on society by the conduct of Dirks and the insider by disclosing the fraud outweighed the losses sustained by the shareholders of Equity Funding.[120]

The Court applied fiduciary duty principles with the new personal benefit test to find that Dirks had not inherited a *Cady, Roberts* duty.[121] Hence he had no duty to abstain from using the information he had received.[122] Dirks would only have had a duty to disclose or abstain if his informants[123] had breached their fiduciary duties to the shareholders by communicating the information to him.[124] The Court concluded that because the insiders did not personally benefit from their transmission of information to Dirks, he could not have committed a derivative breach.[125] In essence, the *Dirks* decision limits tippee liability by requiring that the insider reap personal gain in order for his tippe to inherit a *Cady, Roberts* duty.[126] "Thus, as a practical matter, *Dirks* limited insider trading liability to [traditional] insiders and those tippees [nontraditional insiders] whose trading is beneficial to

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their initiatives to ferret out and analyze information and thus the analyst's work redounds to the benefit of all investors." *Id.* at 658 n.17.

119. *Id.* at 671. Justice Blackman, joined by Justices Brennan and Marshall, criticized the majority opinion in several ways. First, he noted that Secrist, a former Officer of Equity Funding and Dirks' initial source of the information, had "used Dirks to disseminate information to Dirks' clients, who in turn dumped stock on unknowing purchasers. Secrist thus intended Dirks to injure the purchasers of Equity Funding securities to whom Secrist had a duty to disclose." *Id.* Thus, he concluded the majority erred in applying its personal benefit test and should have concluded that Secrist had breached his fiduciary duty and that Dirks committed a derivative breach. *Id.*

Second, Justice Blackman emphasized that the resulting harm to the shareholders was the same regardless of the motive of the tipper. "It makes no difference to the shareholder whether the corporate insider gained or intended to gain personally from the transaction; the shareholder still has lost because of the insider's misuse of nonpublic information." *Id.* at 674.

Third, as noted in the text, the dissent was adamantly opposed to the policy underlying the personal benefit test. *Id.* at 676.

120. *Id.* at 677-78.

121. *Id.* at 666.

122. *Id.* at 667.

123. *Id.* at 649. In addition to Secrist, the former officer of Equity Funding who provided Dirks with the information initially, other employees of Equity Funding disclosed additional information to Dirks during the course of his investigation.

124. *Id.* at 667.

125. *Id.* (insider's motivation was to expose fraud).

126. *See* Note, *Delineating Scope*, *supra* note 1, at 350-51. *See also* Phillips & Zutz, *Repair*, *supra* note 1, at 82-85.

the [traditional] insider."[127] However, to mitigate this overall restriction on nontraditional insider liability, the majority defined the contours of "personal gain" and "insider" quite broadly.[128]

After the *Dirks* decision, the Supreme Court chose not to review any of the lower court decisions interpreting the scope of section 10(b) and Rule 10b-5.[129] *Certiorari* was not granted despite several liberal applications of the misappropriation theory.[130] However, the Second

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127. Phillips & Zutz, *Repair*, *supra* note 1, at 81-82.

128. *See id.* Personal gain was defined quite loosely as illustrated by the court's recognition of the various circumstances in which an inference can be drawn that the insider's breach was motivated by personal gain. For example,

> there may be a relationship between the insider and the recipient that suggests a *quid pro quo* from the latter, or an intention to benefit the particular recipient. The elements of fiduciary duty and exploitation of nonpublic information also exist when an insider makes a gift of confidential information to a trading relative or friend. The tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient.

Dirks, 463 U.S. at 664.

The court also defined the category of insiders broadly by creating a class of constructive or temporary insiders. Phillips & Zutz, *Repair*, *supra* note 1, at 82. In footnote 14 of the majority opinion the Court stated:

> [U]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. 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.

Dirks, 463 U.S. at 646 n.14.

129. *See, e.g.*, SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 105 S. Ct. 2112 (1985) (misappropriation of material non-public information and subsequent trading on that information in violation of § 10(b) and Rule 10b-5); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (S.D.N.Y.), *cert. denied*, 464 U.S. 863 (1983) (indictment charging defendant with violating mail fraud statute, Securities and Exchange Act, and Rule 10b-5). *See also* Low, *Stand*, *supra* note 16, at 3 col. 2 ("[T]he Supreme Court may be reluctant to touch the issue [insider trading] because individual justices are divided and because the Court may be waiting for a conflicting decision from another federal circuit.").

130. *See, e.g.*, SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 105 S. Ct. 2112 (1985) (misappropriation by employee of financial printing company for his own advantage); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y. 1985) (violation of federal securities and wire fraud statutes under the "misappropriation" theory); SEC v. Musella, 578 F. Supp. 425 (S.D.N.Y. 1984) (preliminary injunction barring traders from future securities violations and temporarily freezing defendant's assets); SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983) (improper trading on material nonpublic information).

Circuit's decision in *United States v. Carpenter*[131] has prompted the Court to grant *certiorari*. It is the position of this comment and several commentators[132] that the Second Circuit's decision has stretched the misappropriation theory beyond its reasonable limits, making *certiorari* inevitable.

V. THE PIVOTAL CASE: *UNITED STATES V. CARPENTER*

A. *The Facts*

Carpenter revolves around a widely-read *Wall Street Journal* stock market gossip column entitled "Heard on the Street."[133] Each column contains both negative and positive information about a particular stock or group of stocks; it analyzes trading activity and advises whether to invest in the stock.[134] R. Foster Winans, a reporter and writer for the "Heard" column, and David Carpenter, a news clerk, both were employees of the *Journal* from 1981 until their dismissals in 1984.[135] As employees of the *Journal*, both Winans and Foster were familiar with "The Insider Story," a forty-four page manual distributed to

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131. 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986). On December 15, 1986, the United States Supreme Court granted *certiorari* in *Carpenter*. It thus appears that the time has come for a critical examination of the viability of the misappropriation theory. The decision to review the *Carpenter* case and the numerous incidents of insider trading occurring in the past year has caused the Securities and Exchange Commission to reconsider its strong opposition to the promulgation of a legislative definition of insider trading. According to one top SEC official, "While it would be premature to say the commission supports a definition, I think it's accurate to say we are receptive to the idea . . . and I think there could be some here who want a definition." Nash, *S.E.C. Ponders Insider Law*, N.Y. Times, Mar. 2, 1987, at D2, col. 1. Moreover, another official saw a direct correlation between the outcome of the Supreme Court's forthcoming decision in *Carpenter* and the need for a statutory definition. "If we win Winans, then I think our case law will be sufficient to continue without a definition for awhile . . . but if we lose Winans we're in trouble and really need a definition." *Id.* at col. 2.

132. *See generally* Glaberson, *Did the* Winans *Decision go too Far?*, Bus. Wk., July 8, 1985, at 26, col. 3 [hereinafter Glaberson, *Decision*] ("[C]ritics of the decision are worried that [Judge] Stewart may have stretched the law too far because he was anxious to find Winans guilty of something."); Obermaier, *Inside*, *supra* note 10; Rakoff, *Business Crime*, N.Y.L.J., May 10, 1985, at 1, col. 1 [hereinafter Rakoff, *Business*] ("[N]either he [Winans] nor his co-defendants should be prosecuted on theories of Mail Fraud that at best deprive the criminal law of any moral force and at worst threaten the liberty of all of us.").

133. *See* Rakoff, *Business*, *supra* note 132, at 1, col. 1.

134. *See* Brief for Appellee at 6, United States v. Carpenter, 791 F.2d 1024 (2d Cir.), *cert. granted*, 107 S. Ct. 666 (1986) [hereinafter Brief for Appellee].

135. *Carpenter*, 791 F.2d at 1026.

all new employees by Dow Jones & Company, the *Journal*'s parent company.[136] Seven pages were devoted to the company's conflcits-of-interest policy: "The company deemed all news material gleaned by an employee during the course of employment to be company property. [C]ompany policy required employees to treat nonpublic information learned on the job as confidential."[137] Nevertheless, Winans and Carpenter engaged in a scheme to provide Kenneth P. Felis and Peter Brant, two Kidder Peabody stockbrokers, with information about sec-

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136. The critical portions of the conflicts of interest policy are as follows:

Dow Jones has always had a strict policy on security transactions by employees who have access to inside information regarding unpublished stories . . . . Each employee is expected to bend over backwards to avoid any action, no matter how well intentioned, that could provide grounds even for suspicion:

(a) That an employee made financial gains by acting on the basis of "inside" information obtained through a position on our staff, before it was available to the general public. *Such information includes . . . our plans for running stories, [and] items that may affect price movements. . . .*

(b) that the writing of a news story or item . . . was influenced by a desire to affect the stock's prices;

. . . .

It is important for all employees to keep in mind the *tremendous embarrassment and damage to the Company's reputation that could come about through a lapse in judgment by one person*, no matter how well intentioned that person may be.

. . . .

With these general propositions in mind, here are some specific guidelines:

(i) First and foremost, all material gleaned by you in the course of your work for Dow Jones is deemed to be strictly the Company's property. This includes . . . *information on plans for running items and articles on particular companies and industries* . . . . Such material *must never be disclosed to anyone outside of the Company*, including friends and relatives.

. . . .

(iii) *No employee with knowledge of a forthcoming article . . . concerning a company or industry should, prior to the publication of such article, . . . invest in that company or companies in that industry* . . . .

(iv) Further, any employee having prior knowledge of a forthcoming article, . . . should delay trading in the securities of the companies involved until the general public has an opportunity to read and digest the information . . . . Employees should wait two full trading days . . . .

(v) If an employee should inadvertently buy or sell a security or otherwise invest contrary to the guidelines set forth in (iii) or (iv), ... the employee should notify his or her department head as soon as practical. In the case of a purchase, the employee should hold the security for six months.

Brief for Appellee, *supra* note 134, at Appendix 1a-2a.

137. *Carpenter*, 791 F.2d at 1026.

urities scheduled to appear in "Heard" columns.[138] During 1983 and the beginning of 1984, Felis and Brant set up trading accounts[139] and traded on advance knowledge of about twenty-seven "Heard" columns, producing net profits of approximately $690,000.[140] In November 1983, Kidder Peabody's compliance department became suspicious that Felis had prepublication knowledge of the "Heard" columns. The department had noticed a correlation between the subject matter appearing in the "Heard" columns and Felis' trading activities.[141] When Felis was questioned about this correlation, he denied any wrongdoing and subsequently moved certain funds among the trading accounts and changed their names.[142] Following an investigation, the SEC brought criminal charges against Carpenter, Felis, Winans.[143] The United States DIstrict Court for the Southern District of New York convicted Winans and Felis of securities fraud in violation of section 10(b) and Rule 10b-5; Carpenter was convicted of aiding and abetting in violation of section 10(b) and Rule 10b-5.[144]

B. *The Issue*

Only one question was raised by the facts presented in *Carpenter*:

> [W]hether a newspaper reporter, a former newspaper clerk, and a stockbroker acting in concert, criminally violated federal securities laws by misappropriating material, nonpublic information in the form of the timing and content of the *Wall Street Journal*'s confidential schedule of columns

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138. *Id.* The district court found that "Winans had actual knowledge of the policy, and that Carpenter was aware generally of the policy." *Id.* at 1026 n.1 (quoting United States v. Winans, 612 F. Supp. 827, 831 (S.D.N.Y. 1985) (as amended July 24, 1985)).

139. *Id.* at 1026-27. "Trading accounts were established in the names of Felis, Carpenter, Winans, Brant, David Clark, Western Hemisphere and Stephen Spratt." *Id.* David Clark was a client of Brant's, and Stephen Spratt was a friend of Felis. *Id.* at 1027 n.2. Western Hemisphere was the name used on the Swiss Bank account after Kidder Peabody's compliance department became suspicious about the trading of Felis. *Id.*

140. *Id.* at 1027. Not all of the columns were written by Winans.

141. *Id.*

142. *Id. See also supra* note 139 (use of Swiss bank accounts).

143. *Carpenter*, 791 F.2d at 1027.

144. *Id.* at 1026. Felis and Winans were also convicted of mail fraud in violation of 18 U.S.C. § 1341; wire fraud in violation of 18 U.S.C. § 1343; and conspiracy to commit securities fraud, mail, and wire fraud, and to obstruct justice in violation of 18 U.S.C. § 371. *Carpenter*, 791 F.2d at 1026.

> of acknowledged influence in the securities market, in contravention of the established policy of the newspaper, for their own profit in connection with the purchase and sale of securities.[145]

The Second Circuit answered affirmatively, holding that section 10(b) and Rule 10b-5 proscribe an employee's misappropriation of material nonpublic information from his employer in connection with the purchase or sale of securities.[146]

The court refined the aforementioned issue by noting that under agency principles[147] "[i]t is clear that defendant Winans, as an employee of *The Wall Street Journal*, breached a duty of confidentiality to his employer by misappropriating from the *Journal* confidential prepublication information . . . about which he learned in the course of his employment."[148] Thus, the court focused only upon the question of whether such misappropriation was a violation of section 10(b) and Rule 10b-5.[149] To answer this question, the court reviewed pertinent cases,[150] and stated that "the misappropriation theory . . . proscribes the conversion by 'insiders' *or others* of material nonpublic

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145. *Carpenter*, 791 F.2d at 1027.

146. *Id.* at 1026.

147. *Id.* at 1028 n.5. The court, in a footnote, referred to RESTATEMENT (SECOND) OF AGENCY § 395 (1958), which provides:

> Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge.

148. *Id.* at 1028. "The information misappropriated here was the *Journal*'s own confidential schedule of forthcoming publications. It was the advance knowledge of the timing and content of these publications, upon which appellants, acting secretively, reasonably expected to and did realize profits in securities transactions." *Id.* at 1031. It, therefore, appears that the majority believed that Winans misappropriation of information was not limited to the schedule itself. Instead, Winans' knowledge of the content of these publications played an important role in finding that he had misappropriated confidential information. The dissenting opinion, on the other hand, contended that the majority's holding was based on a finding that the publication schedule itself was the confidential information. *Id.* at 1038 (Miner, J., dissenting). *Cf. id.* at 1031 n.8 (discussing dissenting opinion).

149. *Id.* at 1028.

150. The court reviewed the reasoning used in Dirks v. SEC, 463 U.S. 646 (1983); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983).

information in connection with the purchase or sale of securities."[151] Hence, the court found that Winans was included within the broad scope of the misappropriation theory, and rejected the defendants' argument that the misappropriation theory applied only to insiders or so-called quasi-insiders.[152] The court stated that "[a]lthough *Dirks* disapproved of certain trading by insiders or quasi-insiders who owe a fiduciary duty to investors, courts are not thereby constrained from recognizing other misconduct."[153] The court then reviewed the language of the Rule, citing the repeated use of the word "any" in the Rule as an indication that a broad interpretation was intended and reaffirmed the reasoning of its earlier decisions.[154] Next, an examination of the legislative intent of the 1934 Act as expressed at the time of its enactment and at the time of ITSA's enactment convinced the court that Congress intended the antifraud provisions to be construed expansively.[155] For example, it found that "Congress noted that the intent of the 1934 Act was to condemn all manipulative or deceptive trading 'whether the information about a corporation or its securities originates from inside or outside the corporation.' "[156] The court emphasized that the policy "underlying section 10(b) and the major securities laws generally is the fundamental promotion of the 'highest ethical standards in every facet of the securities industry.' "[157] The majority believed that its expansive interpretation of section 10(b) was consistent with this policy.

Having decided that the defendants were within the scope of section 10(b), the court then analyzed the question of whether defendants' actual conduct was illegal. It determined that Winans' conduct constituted fraud because he " 'misappropriated—stole, to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence.' "[158] Next, the court concluded that this fraud and deceit was perpetrated "upon any person," because "Winans,

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

152. *Id.*

153. *Id.*

154. *Id.* at 1029-30. *See, e.g.*, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972) (repeated use of the word "any" shows the rule is obviously meant to be inclusive).

155. *Carpenter*, 791 F.2d at 1030 ("legislative intent of the 1934 Act is similarly, broad reaching").

156. *Id.*

157. *Id.* at 1031 (quoting *Capital Gains Research Bureau*, 375 U.S. at 186-87).

158. *Carpenter*, 791 F.2d at 1031 (quoting *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting)).

and Felis and Carpenter by their complicity, perpetrated their fraud 'upon' the *Wall Street Journal*, sullying its reputation and thereby defrauding it 'as surely as if they took [its] money.' "[159] Finally, the court was confident that the defendants' fraud was "in connection with" the purchase or sale of securities as required under section 10(b) and Rule 10b-5, because their only purpose for misappropriating the publication schedule was to trade in the securities market.[160]

The defendants argued that Winans should not be barred by section 10(b) and Rule 10b-5 if the *Journal* or the Dow Jones Company could lawfully disregard its own confidentiality policy and trade in the stock of companies to be featured in forthcoming columns.[161] The court's reluctance to rebut this argument conclusively reveals the foundation on which the court apparently based its holding. The court left open the question of whether the *Journal* or its parent company could have traded upon this prepublication information without such trading constituting a manipulative or deceptive device under Rule 10b-5 because the answer was not necessary to the court's analysis.[162] Instead, the court focused upon the *Journal*'s confidentiality policy and the employer-employee relationship, stating, "Appellants, constrained by the employer's confidentiality policy, could not trade by fraudently violating that policy, even if the *Journal*, the employer imposing the policy, might not be said to defraud itself should it make its own trades."[163] Thus, the court's basis for expansion of the misappropriation theory to cover Winans' conduct appears to stem from the violation of his employer's confidentiality policy.

In his dissent, Judge Miner argued that the majority had overly expanded the misappropriation theory and, consequently, the scope of Rule 10b-5.[164] He specifically criticized the majority's conclusion that the publication schedule of the "Heard" columns constituted inside information.[165] He stated that "[k]nowledge of publication dates simply is not the special securities-related knowledge implicated

159. *Id.* at 1032 (defrauded person was Winans' employer, *The Wall Street Journal*).

160. *Id.*

161. *Id.* at 1033. "Appellants argue that it is anomalous to hold an employee liable for acts that his employer could lawfully commit." *Id.*

162. *Id.* at 1033 n.10.

163. *Id.* at 1033 (comparing the employer-employee distinction with the fiduciary-corporate client distinction).

164. *Id.* at 1036 (Miner, J., dissenting).

165. *Id.* at 1037 (Miner, J., dissenting) (publication dates are not "special security-related knowledge").

in the misappropriation theory."[166] In addition, he disagreed with the finding that harm to the reputation of the *Journal* was a proper subject for redress under section 10(b) or Rule 10b-5.[167]

VI. ANALYSIS

It is the position of this comment that the Second Circuit's decision in *Carpenter* has expanded the misappropriation theory, and thus the scope of Rule 10b-5, beyond reasonable limitations. This comment will discuss the reasoning and policy considerations utilized by the majority in *Carpenter* to extend the scope of section 10(b) liability to include outsiders with outside information. It will contend that the lack of a statutory definition contributed to the court's ability to accomplish this undesirble result. Third, it will compare the reasoning employed in the Ninth Ciruit's decision in *Zweig v. Hearst Corp.*,[168] a case involving liability of a columnist, with the reasoning employed in *Carpenter*. Finally, the effect of *Carpenter*'s expansive interpretation of the scope of Rule 10b-5 will be explored.

A. *Criticism of the Majority's Analysis in* Carpenter

1. Information Misappropriated by Winans Was Not Confidential Securities-Related Information Within the Purview of Rule 10b-5

The dissenting opinion of Judge Miner serves as a springboard for criticism of *Carpenter*'s holding that the misappropriation theory could be employed to impose criminal liability on the defendants. Specifically, he noted that prior to the *Carpenter* decision, "the misappropriation theory of criminal liability for securities fraud was applied only to those cases involving the taking and use of nonpublic confidential securities related information by those who obtained that information through special relationships with their sources of knowledge."[169] The majority, however, applied this theory of liability even though the information was not the type of special securities-related knowledge implicated in the misappropriation theory.[170]

While somewhat unclear, the majority apparently based its hold-

166. *Id.*
167. *Id.* at 1036.
168. 594 F.2d 1261 (9th Cir. 1979).
169. *Carpenter*, 791 F.2d at 1036.
170. *Id.* at 1031.

ing upon a finding that the schedule of forthcoming publications was misappropriated.[171] Judge Miner contended that by holding that the publication schedule of a column, information fully available to the public, constituted inside information, the majority "extended the sweep of Section 10(b) and Rule 10b-5 beyond all reasonable bounds."[172] Other critics of the *Carpenter* decision share this view.[173] One critic stated that the publication schedule is a "relatively shrunken idea of 'inside information' and one that doesn't deal with the investment worthiness of a particular stock. It's even flattering to call it market information."[174] The basic distinction between inside and market information is that the former comes from within the corporation while the latter comes from sources outside the corporation.[175] Clearly, knowledge of the publication schedule falls within the category of market information. It might be argued that the defendant's *knowledge of when* the publicly available information was to be disseminated constituted confidential information protected by the Rule. This was not, however, a basis for the court's decision. Instead, the majority contended that the mere existence of an employer confidentiality policy can transform publicly available information into nonpublic information protected by the federal securities laws.

The publication schedule is the internal creation of the *Journal* and misappropriation of this schedule should not be sanctioned by the securities fraud provisions. Instead, as the dissenting opinion suggests, criminal liability may be imposed on an employee who has "failed to disclose to his employer any material information he is under a fiduciary duty to disclose under the mail and wire fraud statutes."[176] In addition, an alternative method of sanctioning this type of misconduct would be, of course, employer action such as dismissal or demotion. Where the employee's breach of duty results from the violation of internal policy, it seems appropriate to allow internal policy to redress the wrongdoing.

Although one could argue that the publication schedule was material inside information under the broad definition of materiality

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171. *See id.* at 1031.

172. *Id.* at 1037 (Miner, J., dissenting).

173. *See* Obermaier, *Inside*, *supra* note 10, at 2, col. 3; Glaberson, *Decision*, *supra* note 132, at 29, col. 3.

174. Obermaier, *Inside*, *supra* note 10, at 2, col. 3.

175. *See supra* text accompanying notes 36-39.

176. *Carpenter*, 791 F.2d at 1037 (Miner, J., dissenting).

espoused by the court in *Texas Gulf Sulphur*, the argument is weak because the publication schedule merely noted what subjects were to be discussed in the future and the substance of the column contained nothing more than gossip.[177] The court in *Texas Gulf Sulphur* stated that information is material if a reasonable man would attach importance to it in making a decision.[178] A reasonable man arguably would not make a decision based solely upon gossip. On the other hand, the defendants obviously attached importance to the publication schedule and the profits reaped indicate that the schedule was in fact material. However, as noted previously, the publication schedule per se is not inside information because it did not emanate from within a corporation whose stock was traded.[179]

2. Breach of Employer's Confidentiality Policy Is an Inadequate Ground on Which to Premise Criminal Violations of Section 10(b)

According to the majority, had there been no confidentiality policy, Winans would have been free to trade on the information he gathered during the course of his employment.[180] The policy, together with other pamphlets, is provided to employees as a part of their orientation.[181] The seven-page policy in question was contained at the end of a forty-four page pamphlet on the description of the Dow Jones Company (the *Journal*'s parent company).[182] "[C]ommon sense suggests that comparatively few Dow Jones employees would bother to read the policy, that fewer still would understand it, and that fewest of all would remember it."[183] Nonetheless, the majority holds that breach of this policy can be sanctioned by criminal law.[184]

The majority's refusal to give an opinion on whether a newspaper's trading on material inside information would constitute a manipulative or deceptive practice under Rule 10(b)-5 is inconsequential. If such trading by a newspaper did not constitute a ma-

177. *See* Rakoff, *Business*, *supra* note 132, at 1, col. 1.

178. *See Texas Gulf Surphur*, 401 F.2d at 849. *See also supra* notes 63-67 and accompanying text (discussion of test for materiality).

179. *Carpenter*, 791 F.2d at 1037.

180. *Id.* at 1033-34.

181. *See* Rakoff, *Business*, *supra* note 132, at 2, col. 5.

182. *See id. See also supra* note 136 (pertinent parts of policy).

183. Rakoff, *Business*, *supra* note 132, at 2, col. 5.

184. *See id.* at 2, col. 5 ("[T]here is nothing in any of this [Policy] that gives rise to any reasonable expectation that the Policy is to be viewed as the government would now have it viewed—as a code of criminal conduct.").

nipulative device, then the *Journal* would be free to disregard its confidential policy and trade upon information similar to that used by Winans.[185] However, the newspaper's survival is dependent upon its reputation.[186] Trading upon information received from its sources would only harm the newspaper; therefore, it is unlikely that newspapers would engage in such trading.[187]

Note, however, the conflicts that arise if the *Journal* could legally trade upon such information and the columnists could not, solely because of an internal policy.[188] If true, "the impact on the securities market [would be] irrelevant, since on an impersonal market like the New York Stock Exchange one cannot identify the actual buyers and sellers."[189] Such a proposition affords little if any investment protection.[190]

B. *The Absence of a Statutory Definition Enabled the Majority to Formulate an Overly Expansive Holding*

The absence of a statutory definition of insider trading allows courts to formulate theories of liability based upon public policy considerations. While such considerations are legitimate, the absence of statutory guidelines has turned the law of insider trading into a playground. While the Second Circuit endorses policy concerns which favor an expansive scope of Rule 10b-5, the Supreme Court places greater emphasis on policy tending to restrict the scope.[191] The majority in *Carpenter* based its holding on protecting the *Journal*'s reputation from injury.[192] Such unbridled discretion might not be available to the courts if there was an explicit statutory definition of insider trading.[193] The effect of this policy merry-go-round is to leave investors with a cloudy perception of the law of inside trading.

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185. *Carpenter*, 791 F.2d at 1033 n.10.

186. *Id.* The court stated, "[A] reputable newspaper, even if it could lawfully do so, would be unlikely to undermine its own valued assets, its reputation, which it surely would do by trading on the basis of its knowledge of the forthcoming publications." *Id.*

187. *Id.*

188. *See* Obermaier, *Inside*, *supra* note 10, at 2, cols. 3-4.

189. *Id.* at 2, col. 4.

190. *Id.*

191. *See, e.g.*, Dirks v. SEC, 463 U.S. 646 (1983). *See also supra* notes 152-55 and accompanying text (opining that post-*Dirks* lower court decisions have adopted an improperly liberal view of the scope of § 10(b) and Rule 10b-5).

192. *Carpenter*, 791 F.2d at 1037 (Miner, J., dissenting).

193. *See* Glaberson, *Decision*, *supra* note 132, at 30, col. 2 (suggested that Judge Stewart, district court judge in *Winans*, may have stretched the law too far because he was anxious to find Winans guilty of something).

C. *The Effect of Imposing Rule 10b-5 Liability on Reporters: A Look at* Zweig v. Hearst Corp

A comparison of the reasoning in *Zweig v. Hearst Corp.*[194] with that in *Carpenter* will illustrate that the desire for an expansive interpretation of Rule 10b-5 is not limited to those cases decided by the Second Circuit. A review of the *Zweig* case is helpful in gaining a greater understanding of the impact of Rule 10b-5 liability on reporters.

Zweig involved the liability of a financial columnist, Alex Campbell, an employee of the Hearst Corporation.[195] Campbell's column was published five days a week in the *Herald Examiner*, a Hearst publication.[196] Campbell wrote a column about American Systems Inc. (ASI) which praised its management and products.[197] Campbell did not, however, disclose in this article that he had recently purchased shares in ASI.[198] The plaintiff alleged that as a result of the article, the price of ASI stock rose dramatically and Campbell reaped a substantial gain by selling some or all of his stock at the increased price.[199] After the district court granted Campbell's motion to dismiss, the Ninth Circuit remanded and found that Campbell could be liable under Rule 10b-5 for failing to disclose to his readers his intentions to trade in ASI stock.[200] After enunciating the existence of this broad duty, the court attempted to mitigate its holding by stating: "While Rule 10b-5 should not be extended to require every financial columnist or reporter to disclose his or her portfolio to all of his or her readers, it does cover the activities of one who uses a column as part of a scheme to manipulate the market and deceive the investing public."[201] To apply this limitation to the court's holding, it is

194. 594 F.2d 1261 (9th Cir. 1979).

195. *Id.* at 1262.

196. *Id.* (plaintiffs sued Campbell, the Hearst Corporation, and directors of American Systems, Inc., a corporation which was the subject of a column authored by Campbell).

197. *Id.* at 1264-65 (column cast ASI in a more favorable light than it deserved).

198. *Id.* at 1264 (Campbell purchased directly from ASI 5,000 shares of stock at $2 per share while the bid price on that same day was 3 5/8).

199. *Id.* at 1265. Experts testified that ASI stock would not have risen above $3.25 without Campbell's column, nonetheless, the bid price rose to $4.25 within a week after Campbell's column appeared. *Id.* The day after his article appeared, Campbell sold 2,000 of his 5,000 ASI shares at the inflated price while retaining the remaining 3,000 shares for future profits. *Id.*

200. *Id.* at 1271 (district court granted motion to dismiss, Ninth Circuit remanded).

201. *Id.*

necessary to determine in what circumstances a reporter can be said to use his column manipulatively.[202] As one critic noted, "*Zweig* suggests that readers have a Rule 10b-5 action whenever a reporter omits a material fact that might affect the reporter's impartiality. Under this reading of Rule 10b-5, there is no reason to limit the disclose or refrain obligation to journalists recommending particular stocks."[203] However, the *Zweig* holding is weak in light of *Chiarella* and *Dirks*,[204] where the Supreme Court impliedly ruled out the possibility that a *Cady, Roberts* obligation could arise between the nontraditional insider and the public. The Supreme Court explicitly stated that the duty to disclose or abstain arises only in the context of a fiduciary relationship,[205] and in *Zweig*, the court did not find any such relationship between the columnist and the public.

Like Winans, Campbell was a nontraditional insider who employed market information for personal gain. However, Campbell's source of information was his own personal knowledge of the market, while Winans' source of information was his employer. In one sense, there appears to be less justification for imposing liability on Campbell than on Winans because Campbell's knowledge was not obtained through fraudulent means. On the other hand, Campbell's column recommended a particular stock and thus falls more clearly within the category of market information than does a publication schedule of forthcoming columns whose subject matter is gossip available to the general public. Therefore, it could be argued that Campbell's information was more like the type of securities-related information with which Rule 10b-5 is concerned and that Campbell should be sanctioned.

As a result of *Chiarella* and *Dirks*, the reasoning employed by the Second Circuit in *Carpenter* was tailored to the fiduciary duty

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202. See Note, *Inadequacy, supra* note 4, at 1558, where the author recognizes the dilemma of a reporter faced with potential liability from writing a column:

> Unfortunately, the proposed limitation begs the question of when a reporter uses his column as part of a scheme to manipulate the market and deceive investors. If a reporter trades on his own superior analysis, knowing—but not intending—that the market will react to his column, does he use the column as a part of a scheme or manipulation? Does he deceive the investing public?

Id.

203. *See id.* If a reporter "reports on a scandal in the oil industry, for example, must he disclose his trades in a particular oil-company security or his trades in the shares of companies in a competing industry such as coal?" *Id.*

204. *See id.* at 1558.

205. *See Dirks*, 463 U.S. at 664-65; *Chiarella*, 445 U.S. at 242-33.

principle. Under the misappropriation theory, the court was able to base Winans' liability on his breach of fiduciary duty owed to his employer.[206] While the analyses employed by *Zweig* and *Carpenter* proceed in different directions, the result is the same and the message is clear: Reporters Beware!

D. *Ramificaions of the Second Circuit's Expansive Holding in* United States v. Carpenter

The expansive interpretation of Rule 10b-5 in *Carpenter* has enhanced the uncertainty surrounding the law of insider trading.[207] By holding that through a breach of an employer's internal policy governing confidentiality an employee may be held criminally liable under the Rule,[208] the Second Circuit has divorced from the law the idea that insider trading victimizes the affected corporation and its shareholders. Moreover, expansion of the Rule to protect the reputation of a financial newspaper, a newly recognized concern of the court,[209] indicates that the Second Circuit is willing to go to great lengths to arrive at a policy that will support liability if it believes there has been the slightest impropriety.[210]

In addition, because *Carpenter* revolved around the dealings of newspaper employees, there is a special concern among journalists about the decision.[211] "[T]he Winans Case reminded editors that it is better to be safe than sorry [and] [m]any [have] toughened their existing standards. . . . At some publications, such as *The Washington Post*, business writers are required to file an annual report listing all their personal investments."[212] The purpose behind such precautions is twofold: "to protect honest employees from the appearance of impropriety [and] to make it easier to fire violators."[213] As indicated above, the court's ruling has concerned not only the editors of financial newspapers, but also publications whose primary focus is

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206. *See Carpenter*, 791 F.2d at 1028.
207. *See* Glaberson, *Decision*, *supra* note 132, at 29, col. 3.
208. *Carpenter*, 791 F.2d at 1034.
209. *Id.* at 1037 (Miner, J., dissenting).
210. *See* Glaberson, *Decision*, *supra* note 132, at 29, col. 3.
211. *See* Adler, Conant & Tsuruoka, *Trouble on the Street*, Newsweek, Feb. 4, 1985, at 59, cols. 1-3.
212. *Id.* at col. 3.

not on the business community. While the court's emphasis in *Carpenter* was upon the injury sustained to the reputation of a financial newspaper, it would not be surprising for the Second Circuit to extend the scope of the Rule to prevent injury to the reputations of all types of mass media, including general interest newspapers, magazines and television newscasts.

Breaches of confidences between employer and employee should be sanctioned internally by the employer. The federal securities laws, designed to combat fraudulent activity, should not be manipulated to govern the employer-employee relationship where sufficient mechanisms exist to punish undesired employee conduct.

VII. CONCLUSION*

Judicial insider trading prohibitions have traditionally been based upon section 10(b) of the 1934 Act and Rule 10b-5 which are broadly couched in terms of fraudulent conduct. It has, therefore, been necessary for the courts to create theories that are capable of linking insider trading to fraudulent conduct. Initial interpretations of the scope of Rule 10b-5 were broad, focusing upon the inherent unfairness of allowing persons with inside information to trade in the marketplace. Application of Rule 10b-5 to traditional insiders who traded

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* At the time of this publication, the Supreme Court of the United States was scheduled to hear oral argument in *United States v. Carpenter* on October 7, 1987.

213. *Id.*

Appendix

Individual's Relation to Company & Source of Information

Traditional Insider & *Inside Information*	*Nontraditional Insider* & *Inside Information*
SEC v. Texas Gulf Sulphur	Shapiro v. Merrill Lynch Dirks v. SEC *In re* Cady, Roberts
Traditional Insider & *Outside Information*	*Nontraditional Insider* & *Outside Information*
	United States v. Carpenter Zweig v. Hearst United States v. Chiarella

on the basis of inside information was a relatively easy task for the courts. It was, however, the expansion of the Rule's scope to cover traditional insiders with market information and nontraditional insiders with either market or inside information that has caused problems for the judiciary.

The Supreme Court's interpretation of the Rule has been consistently restrictive. The Second Circuit, on the other hand, has repeatedly endorsed a broad application of the Rule. The obvious consequences of this conflict have been ambiguity in the law and uncertainty among market participants.

Adding to this preexisting ambiguity is the decision in *Carpenter*, which employed the misappropriation theory to find a reporter who had violated an internal policy of his employer guilty of a criminal violation of Rule 10b-5. Moreover, the type of information which the Second Circuit sought to protect in *Carpenter*, a schedule of forthcoming publications, is arguably not the type of nonpublic information which the securities laws are designed to protect. The decision in *Carpenter* expanded the scope of insider trading liability dramatically. Moreover, the decision illustrates how the misappropriation theory enables the court to rely upon policy considerations which support the imposition of criminal liability on individuals guilty of moral wrongdoing.

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