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COMMENTARY

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I. INTRODUCTION

The Insider Trading Sanctions Act of 1984 is, on its face, a simple piece of legislation. At the urging of the Securities and Exchange Commission (SEC), Congress added section 21(d)(2) to the Securities Exchange Act of 1934[1] to give the SEC the authority to

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1. Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified at 15 U.S.C. § 78u(d)(2) (Supp. 1984)). This penalty provision was the principal reason for the legislation, and far and away its most significant feature. The 1984 Act also makes some changes to other enforcement related portions of the securities laws, §§ 3(a)(39), 15(b)(4), and 15(c)(4) of the Securities Exchange Act, 15 U.S.C. §§ 78c(39), 78o(b)(4), 78o(c)(4) (1982), and increases the criminal fine for securities law violations. These changes—described at 130 CONG. REC. H7758-59 (daily ed. July 25, 1984) — are beyond the scope of this Commentary. For practical discussions of the Act, see Stevenson, *The Insider Trading Sanctions Act: Some Unfinished Business Ahead*, Nat'l L.J., Oct. 15, 1984, at 18, col. 1; Levine, *Insider Trading Act Broadens Enforcement Scope*, Leg. Times of Wash., Sept. 10, 1984, at 17, col. 1. For a preenactment overview, see Lynch, *The Insider Trading Sanctions Act: New Remedies for the SEC*, 31 FED. BAR NEWS & J. 166 (1984).

seek civil penalties against persons who violate the prohibition against "insider trading"[2] of up to three times the profits made or losses avoided by the trader.

But this recent legislation means much more than the addition of a new form of remedy. True, the legislative history makes quite clear that Congress did not intend the new law to address, in any direct fashion, the substantive elements of a violation of rule 10b-5 as it applies to insider trading.[3] A familiar canon of statutory construction, however, is that when a statute fails to change the prevailing judicial construction of some prior enacted provision, that failure constitutes an implied endorsement of judicial interpretation, at least to the extent that Congress was aware of the construction and there was a natural opportunity for revision.[4] That maxim applies to the 1984 Act, a fortiori. Congress hardly could be expected to enhance so considerably the enforcement capacity of the SEC when it was dissatisfied with the substantive grounds on which the Commission could bring its actions. Indeed, the legislative history shows that the drafters demonstrated a substantial familiarity with the prevailing law, actively considered addressing that law, but determined not to do so.

In two recent cases, *Chiarella* v. *United States*[5] and *Dirks* v. *SEC*,[6] the Supreme Court imposed a confining doctrinal structure on the prevailing law of insider trading—a structure that can be justified, if at all, as a way of promoting greater orderliness in this subject area.[7] The most interesting aspect of the new legislation is that while the drafters formally accepted this restrictive approach, at the same time they strongly expressed an intention that the legal doctrine of insider trading restrictions be inventive and result

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2. "Insider trading" is used in this Commentary as a shorthand for any activity that violates an antifraud prohibition against trading while the offender is in possession of material nonpublic information. This prohibition thus may include liability for violators who are in no sense "insiders" of the company whose shares are being traded. *See infra* text accompanying notes 70-76.

3. 130 CONG. REC. H7758 (daily ed. July 25, 1984).

4. *See* Herman & MacLean v. Huddleston, 103 S. Ct. 683, 689 (1983); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, 102 S. Ct. 1825, 1841 (1982); Lorillard v. Pons, 434 U.S. 575, 580-81 (1978); *see also* 2A C. SANDS, STATUTES AND STATUTORY CONSTRUCTION § 49.09 (4th ed. 1973); Agusti, *The Effect of Prior Judicial and Administrative Constructions on Codification of Pre-Existing Federal Statutes: The Case of the Federal Securities Code*, 15 HARV. J. ON LEGIS. 367 (1978).

5. 445 U.S. 222 (1980).

6. 103 S. Ct. 3255 (1983).

7. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 17 n.68 (1982).

oriented—flexible enough to reach a wide range of abuses. This legislative schizophrenia will, no doubt, further complicate and convolute the evolution of insider trading theory. This Commentary will consider the new remedy and the effect of its adoption.

II. The Section 21(d)(2) Remedy

A. *Background*

In recent years, insider trading enforcement has become the most visible of the SEC's programmatic efforts—achieving a level of emphasis in the present SEC similar to that of pursuit of foreign bribery, corporate slushfunds, and dishonest management in the mid and late 1970's. Notwithstanding an increasing level of academic controversy over the very propriety of insider trading prohibitions,[8] aggressive enforcement in this area has had bipartisan political support within the SEC,[9] and as the new Act illustrates, bipartisan support in Congress as well. Economic theory has fallen to the simple reality that a crusade for "fair play" in the marketplace has undeniable political appeal.

How best to deter insider trading, however, has been a problem. Until recently, criminal prosecutions were relatively rare—there was no comparable enforcement commitment at the Department of Justice. SEC civil actions were common, but courts effectively limited relief to disgorgement of profits and an injunction against future violations. In light of the difficulty of catching insiders who trade in the first place, these SEC civil actions were not seen as an effective deterrent.[10] The only other form of deterrence was the class action based private remedies for damages—an uncertain mechanism in any event. Class actions did, at least, provide an *in terrorem* possibility for a period following the Second Circuit's decision in *Shapiro v. Merrill Lynch, Pierce, Fenner &*

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8. *See, e.g.*, H. Manne, Insider Trading and the Stock Market (1966); Carlton & Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857 (1983); Dooley, *Enforcement of Insider Trading Restrictions*, 66 Va. L. Rev. 1 (1980); Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets*, 54 S. Cal. L. Rev. 1217 (1981).

9. Some people feared that with the advent of the Reagan Administration, the SEC would retreat from its policy of aggressive securities law enforcement. To some extent, the Commission used the insider trading program as a vehicle for dispelling this general notion. The SEC has denied that it has *overemphasized* insider trading enforcement. *See* 15 Sec. Reg. & L. Rep. (BNA) No. 11, at 567 (Mar. 18, 1983).

10. For an expression of judicial frustration with the inadequacy of this remedy, see SEC v. Randolph, 564 F. Supp. 137 (N.D. Cal. 1983), *rev'd*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 91,576 (9th Cir. June 29, 1984).

Smith, Inc.,[11] apparently giving standing to sue for injury suffered by virtue of nondisclosure to everyone in the marketplace who sold between the time the insider bought (or bought, if the insider sold) and the time of disclosure of the relevant information. That holding raised the possibility of damages awards far in excess of the defendant's gains.

Two events in 1979 and 1980 focused the SEC's attention on the need for a superior enforcement mechanism. One was the SEC's deliberations over the American Law Institute's proposed Federal Securities Code. The drafters of the Code had retained the *Shapiro* approach regarding standing, but had limited class recovery, effectively, to the amount of profits made or losses avoided by the trader—eliminating the *in terrorem* effect.[12] Altering the damages provision was a high priority of the SEC staff in discussions with the drafters concerning possible SEC support for the Code; the staff proposed a "multiple of disgorgement"—three times the profits realized by the inside trader—as a preferable approach. Notwithstanding objections that such a measure would be purely punitive and out of sync with the Code's generally compensatory approach to damages, the staff and drafters compromised on a proposal that gave courts discretion to award the plaintiff class 150% of profits realized or losses avoided.[13] In September 1980 the SEC endorsed the Code, subject to this altered damage provision and a number of other changes.[14] The other event, also in 1980, was the Second Circuit's decision in *Elkind v. Liggett & Myers, Inc.*,[15] which essentially followed the original Code approach of simple disgorgement, and incorporated it into the current law. The SEC petitioned for rehearing, raising the same concerns about deterrence that it had raised with the Code's drafters and suggesting a similar type of remedy. The Second Circuit denied rehearing, and the *in terrorem* effect was, for the present, gone.

Thus, by the end of 1980, the SEC had both focused on the

11. 495 F.2d 228 (2d Cir. 1974). *But see* Fridrich v. Bradford, 542 F.2d 307 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977) (damages not recoverable absent showing of actual injury to class members).

12. Fed. Sec. Code §§ 1603, 1708(b)(2)(B) (1980).

13. Fed. Sec. Code § 1708(b)(4) (Supp. 1981).

14. *See* Rel. No. 33-6242, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,655 (Sept. 18, 1980).

15. 635 F.2d 156, 168-73 (2d Cir. 1980), discussed in Recent Development, *Damages for Insider Trading in the Open Market: A New Limitation on Recovery Under Rule 10b-5*, 34 Vand. L. Rev. 797 (1981); *see also* Wilson v. Comtech Telecomm. Corp., 648 F.2d 88, 95 (2d Cir. 1981) (class limited to "contemporaneous" traders).

lack of deterrence problem and developed a proposed solution. With the step-up in efforts against insider trading leading to greater public attention—later followed by a substantial increase in political interest when two Reagan Administration officials became the subjects of insider trading allegations[16]—the SEC sensed the opportunity to seek congressional enhancement of its powers and the new form of deterrence.

In September 1982 the SEC submitted a draft legislative proposal that would allow it to seek up to three times profits made or losses avoided as a civil penalty, and would increase the maximum criminal penalty for all securities law violations from $10,000 to $100,000.[17] The House of Representatives held committee hearings in April 1983 on the resulting bill, H.R. 559.[18] The House passed the bill, without objection, on September 19, 1983.[19] The Senate acted more slowly. Senator D'Amato of New York, the chairman of the Senate securities subcommittee, wished to address a number of additional issues, including the definition of insider trading. He held hearings in April 1984, with most of the discussion directed at how to define the prohibited act.[20] On June 29, 1984, the Senate discharged the committee from further consideration of H.R. 559. The text of a companion bill, S. 910, which incorporated most of the substance of the House bill but added some important new items, became the operative proposal that the Senate then passed by voice vote.[21] On July 25 the House accepted all of the Senate amendments, eliminating the need for a joint conference.[22] Not-

16. The officials charged with violations were former Deputy Defense Secretary Paul Thayer and former White House national security adviser Thomas C. Reed. Their cases are discussed in 130 CONG. REC. H7757-58 (daily ed. July 25, 1984). The Reed matter received intense Congressional scrutiny. *See The SEC's Investigation of Thomas Reed: Hearing Before the Subcommittee on Securities*, 98th Cong., 1st Sess. (1983).

17. Letter from SEC Chairman John Shad to Hon. Thomas P. O'Neill, Jr., with accompanying memorandum (Sept. 27, 1982), *reprinted in* H. R. REP. No. 355, 98th Cong., 1st Sess. 19-27 [hereinafter cited as SEC Proposal].

18. *Insider Trading Sanctions and SEC Enforcement Legislation: Hearing on H.R. 559 Before the Subcomm. on Telecommunications, Consumer Protection and Finance*, 98th Cong., 1st Sess. 1 (1983) [hereinafter cited as *House Hearings*]. The House Committee on Energy and Commerce reported on the bill in H.R. REP. No. 355, 98th Cong., 1st Sess. (1983) [hereainfter cited as HOUSE REPORT].

19. *See Bill to Allow Treble Damagtes for Insider Trading Passes House*, 15 Sec. Reg. & L. Rep. (BNA) No. 37, at 1773 (Sept. 23, 1983).

20. *The Insider Trading Sanctions Act of 1983: Hearing on H.R. 559 Before the Subcomm. on Securities*, 98th Cong., 2d Sess. (1984) [hereinafter cited as *Senate Hearings*].

21. *See Senate Passes Insider Trading Bill, Includes Treble Damages, No Definition*, 16 SEC. REG. & L. REP. (BNA) No. 27, at 1135 (July 6, 1984).

22. *See House Adopts Senate Version of Bill to Increase Insider Trading Penalties,*

withstanding last minute objections to the legislation by the Office of Management and Budget, the President signed the legislation on August 10, 1984.[23]

B. *The Civil Penalty*

Section 21(d)(2) permits a court, in an action brought by the SEC, to impose a civil penalty of up to three times the trading gains, or losses avoided, on traders and tippers upon finding a violation of rule 10b-5 or any other provision or rule under the Securities Exchange Act that prohibits insider trading. This penalty is paid into the United States Treasury. The legislative history states: "Payment of a civil penalty by any person does not extinguish the liability of any other person. . . . The Commission may, in its discretion, seek a penalty from any or all persons covered by this provision."[24] That is to say, if *X* tips *Y* some inside information allowing *Y* to profit by $50,000, *X* and *Y* each may have to pay up to $150,000.

The new Act does not set guidelines for the exercise of the court's discretion in determining the amount of the penalty. In proposing the legislation, the SEC stated only that the amount should be determined "in light of the facts and circumstances."[25] Presumably, the issue will be resolved, much the way it is resolved in other criminal and civil fine contexts, by taking due account of the financial resources of the defendant, the degree of culpability and sophistication of the defendant, and related common factors. Based on the strong legislative expression of the need for deterrence and the difficulty of detection of criminal infractions, it is appropriate—at least insofar as the sophisticated trader is con-

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16 SEC. REG. & L. REP. (BNA) No. 30, at 1243 (July 27, 1984).

23. *See Reagan Signs Insider Trading Bill with Treble Damages, No Definition,* 16 SEC. REG. & L. REP. (BNA) No. 33, at 1383 (Aug. 17, 1984). White House concerns were noted in SEC Today Nos. 143, 145 (July 24, 26, 1984).

24. 130 CONG. REC. H7758 (daily ed. July 25, 1984) (statement by Rep. Dingell). This floor statement by Mr. Dingell, chairman of the House Committee on Energy and Commerce, is particularly significant in the legislative history for it offers an official explanation and clarification of the Senate amendments in which the House acquiesced.

25. SEC Proposal, *supra* note 17, at 25. In a Memorandum from the SEC's Office of the General Counsel dated April 12, 1983, and transmitted to Representative Rinaldo, the SEC staff indicated that one example in which less than a 300% penalty might be warranted is derivative liability—for example, when an employee improperly trades on a firm's behalf. *See House Hearings, supra* note 18, at 44; *see also* HOUSE REPORT, *supra* note 18, at 8-9. For a discussion of standard-setting in administratively imposed penalties, see Diver, *The Assessment and Mitigation of Civil Money Penalties by Federal Administrative Agencies,* 79 COLUM. L. REV. 1435, 1461-71 (1979).

cerned—to treat the 300% civil penalty figure as the rule, not the exception.[26]

The legislation applies "whenever it shall appear to the SEC that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information."[27] Therefore, a violation of any antifraud provision of the Securities Exchange Act, principally rules 10b-5 and 14e-3,[28] could give rise to the penalty insofar as trading on the basis of material nonpublic information is concerned. The new penalty, however, applies only to trading "on or through the facilities of a national securities exchange or from or through a broker or dealer"[29] and "not as part of a public offering by an issuer of securities."[30] The SEC placed this restriction in the law to emphasize that the Act's purpose is protecting the integrity of the impersonal markets; alternative remedial mechanisms and protections are more readily available and effective when buying or selling is face-to-face or in connection with a public offering. Thus, the need for additional deterrence is not as compelling.[31]

To measure profits gained or losses avoided, the court must calculate the difference between the purchase or sale price and the trading price within "a reasonable period after public dissemination of the nonpublic information."[32] In arriving at this formulation, the drafters specifically chose not to measure profit by the

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26. Under both rules 10b-5 and 14e-3, a person may commit a violation without appreciating the illegality of his actions. In the rare case in which a person did not fully understand the wrongfulness of his trading, treble profits may be excessive. Typically, the illegal trading pursued by the SEC is characterized by careful attempts at secrecy and deception, in which case the maximum penalty is appropriate. In its proposal letter the SEC gave some indication that the treble profits remedy was to be a presumption, reducible "in appropriate cases." SEC Proposal, *supra* note 17, at 25 n.48.

27. Securities Exchange Act of 1934, § 21(d)(2)(A), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified 15 U.S.C. § 78u(d)(2)(A) (Supp. 1984)).

28. The language of the statute refers to any provision of the Exchange Act; hence, a violation of § 15(c), which prohibits certain frauds by broker-dealers, could be covered as well.

29. Securities Exchange Act of 1934, § 21(d)(2)(A), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified 15 U.S.C. § 78u(d)(2)(A) (Supp. 1984)).

30. *Id.*

31. *See* SEC Proposal, *supra* note 17, at 26. When a transaction is face-to-face, there is a clear incentive on the part of the defrauded person to sue. In a public offering the strict disclosure requirements imposed under the Securities Act presumably will prevent most forms of abuse. Securities Exchange Act of 1934, § 21(d)(2)(B), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified 15 U.S.C. § 78u(d)(2)(B) (Supp. 1984)).

32. Securities Exchange Act of 1934, § 21(d)(2)(B), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified 15 U.S.C. § 78u(d)(2)(B) (Supp. 1984)).

difference between the defendant's purchase and sale prices.[33] Thus, if an insider buys at five, watches as the stock goes up to ten shortly after public disclosure and sells six months after disclosure at fifteen, the gain per share is five, not ten. On the other hand, if six months later, when the sale takes place, the price has gone back to five, so that there is no actual profit at all, there is still a paper profit of five on which to base the penalty. As to what constitutes a "reasonable period," there is a good deal of case law discussing the determination of when the information can be expected to be reflected in the market price.[34] For the most widely traded issuers—those having highly liquid, efficient markets—the price may reflect the information in a matter of hours, if not minutes.[35] In addition to the size of the issuer, a court should take into account the nature of the information. Some new data, such as increased earnings projections or dividends, can be evaluated extremely rapidly; other more subjective types of disclosures may take more time to digest intelligently. A useful presumption is the average trading price the day after disclosure, which could then be adjusted if the nature of the issuer, the market, or the information so requires.[36]

Another important point about the penalty is that it may be collected *in addition to* any other remedies directed against the

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33. *See* House Report, *supra* note 18, at 11-12. In a 1983 case the SEC argued that the purchase-sale differential was preferable from a deterrent standpoint. The First Circuit rejected this view. *See* SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983). Given the treble measure of the new Act, courts do not have to stretch the definition of profit beyond logical interpretation in order to achieve the deterrence goal. *See* Letter from SEC Chairman John Shad to Congressman Wirth (June 29, 1983) [hereinafter cited as SEC letter of June 29, 1983], *reprinted in* House Report, *supra* note 18, at 29.

The new Act's formula could still result in over or under penalization. Movements in the price of shares being traded may occur for reasons unrelated to the information in question. For example, assume an insider might buy at 5 based on confidential data about an ore strike. A week later, an unexpectedly favorable unrelated development in the industry causes the stock to go up to 8. The confidential data is then made public, causing the stock to go to 12. In essence, the profit made from the misuse of the information is 4. Nonetheless, the profit for purposes of the penalty will be 7, for a possible penalty of $21 per share.

34. The timing issue arises with respect to the question of how soon after a public statement an insider can trade, *see* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854 & n.18 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), as well as what class of persons can sue the insider and the damages they can recover in a private action, *see* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971), *cert. denied*, 404 U.S. 1004 (1972).

35. For an empirical study of the timing issue, see Patell & Wolfson, *The Intraday Speed of Adjustment of Stock Prices to Earnings and Dividend Announcements*, 37 J. Fin. Econ. 223 (1984).

36. Given the trebling mechanism, there is no reason to worry that the insider might benefit unduly or be underpenalized from too short a "reasonable period."

wrongdoer.[37] The SEC, therefore, could obtain both disgorgement of profits and treble profits as a penalty—for all practical purposes, a quadruple profits sanction. In the above illustration, when the wrongful profit is five dollars per share, the insider may have to pay five dollars as disgorgement and fifteen dollars as a penalty, for a total of twenty dollars a share. A court should not reduce the civil penalty simply because disgorgement also has been granted; these remedies, according to the legislative history, are cumulative and serve entirely different purposes.

The legislative history refers to the availability of private rights of action against insider trading in two contexts. First, because of questions as to standing and the disgorgement measure, participants in the hearing noted the inadequacy of the private remedy as an effective deterrent.[38] Second, some of the drafters implicitly assumed the availability of the private action in describing the alternative remedies available to the SEC. According to the House Report, for instance, a court might place the disgorged funds in an escrow account to be used to compensate those harmed by the insider trading.[39]

Logically, the measure of damages in a private action should not be affected by the existence of a section 21(d)(2) penalty. *Elkind* is a functionally sensible decision—the open-market abstain or disclose requirement is simply a way of preventing unjust enrichment, and hence the most sound remedy is disgorgement—although the *Elkind* damage measure does beg some conceptual problems.[40] The only forceful argument against disgorgement has been its inadequacy as a deterrent, an argument that substantially loses its force as a result of the Act's passage. One would expect *Elkind*, therefore, to become more firmly established as the prevailing approach.

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37. *See* HOUSE REPORT, *supra* note 18, at 8.

38. *See House Hearings*, *supra* note 18, at 119 (testimony of Dennis J. Block).

39. HOUSE REPORT, *supra* note 18, at 8; *see also* SEC Proposal, *supra* note 17, at 25. For a case exploring the relationship, between SEC-obtained disgorgement and private rights, see SEC v. Certain Unknown Purchasers, [1983 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,424 (S.D.N.Y. July 25, 1983).

40. *See* Langevoort, *supra* note 7, at 38-39; *see also* Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 391-97 (1984). Plainly, there is no basis for arguing that the 1934 Act impliedly allows private litigants to recover any form of "penalty" assessment.

C. *Secondary Liability*

A politically sensitive issue during consideration of the penalty provision was the degree to which courts should impose penalty liability on persons other than actual traders or tippers. In dealing with these questions, the drafters have touched on some important issues that extend beyond the insider trading context.

1. Controlling Person Liability

Section 21(d)(2)(B) states that "section 20(a) of this title shall not apply to an action brought under this paragraph."[41] Section 20(a) imposes joint and several liability on certain controlling persons for damages assessed on their agents or functionaries.[42] The intent of this exemptive sentence is to assure, for example, that an investment banking firm that employs a person who trades for his own account based on inside information, or tips others, does not automatically become liable as a "deep pocket" for the penalty.[43] The firm may, of course, still face section 20(a) liability in an appropriate SEC or private action for its employee's disgorgement obligations, but the firm does not have to pay the penalty.[44]

Subsection (B) also states that "no person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph."[45] This sentence is by no means redundant. The SEC's view, endorsed by a majority of courts, is that, quite apart from section 20(a), the common-law doctrine of respondeat superior makes employers and other principals liable for the acts of their employees and agents done in the course of

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41. Securities Exchange Act of 1934, § 21(d)(2)(B), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified 15 U.S.C. § 78u(d)(2)(B) (Supp. 1984)).

42. Section 20(a) makes the controlling person liable unless he "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." 15 U.S.C. § 78t(a) (1982).

43. *See* HOUSE REPORT, *supra* note 18, at 9-10; SEC letter of June 29, 1983, *supra* note 33, at 28-29.

44. Section 20(a) contain a good faith defense, which protects the controlling person if he can demonstrate that he "maintained and enforced a reasonable and proper system of supervision . . . over controlled persons so as to prevent, so far as possible, violations" of the law. Zweig v. Hearst Corp., 521 F.2d 1129, 1134-35 (9th Cir.), *cert. denied*, 423 U.S. 1025 (1975); *see* Note, *Rule 10b-5—The Equivalent Scope of Liability Under Respondeat Superior and Section 20(a) — Imposing a Benefit Requirement on Apparent Authority*, 35 VAND. L. REV. 1383, 1400-04 (1982). The effect of the new Act's exemption, therefore, is to protect from the treble penalty those controlling persons whose only role in the impropriety was a failure to supervise.

45. Securities Exchange Act of 1934, § 21(d)(2)(B), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified 15 U.S.C. § 78u(d)(2)(B) (Supp. 1984)).

employment and designed for the employer's benefit.[46] This sentence, therefore, is designed to assure that the SEC does not use the respondeat superior theory of secondary liability to circumvent the limitation on section 20(a).[47] The addition of this sentence raises two points. First, it represents an explicit statutory recognition of the respondeat superior theory, and should finally resolve what had been a split between the circuits as to whether that common-law doctrine remained available.[48] Second, by focusing closely on "employment," the statutory phrasing technically leaves open other relationships that might give rise to common-law derivative liability.[49] For example, could a law firm be liable for a penalty when one of its partners tips or trades? If the intent of the provision is to hold only actual tippers and traders liable for the penalty as the legislative history indicates, then the answer should be no.

2. Principal Liability

The most interesting interpretive question under the 1984 Act arises when an employee trades for the account of his employer while either he or someone else in the firm possesses inside information. Is the firm then liable?[50] Obviously, if the board of directors or senior management both possess the information and direct or authorize an employee to trade on the company's behalf, the company itself is the principal violator and should be liable for the penalty.[51] The result is less obvious when only a junior employee

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46. *E.g.*, Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir.), *cert. denied*, 449 U.S. 1011 (1980); Fey v. Walston & Co., 493 F.2d 1036, 1052 (7tb Cir. 1974); Note, *supra* note 44, at 1387-89.

47. HOUSE REPORT, *supra* note 18, at 10.

48. In the Third and Ninth Circuits, courts held that § 20(a) was the exclusive source of liability. *E.g.*, Christoffel v. E.F. Hutton, 588 F.2d 665 (9th Cir. 1978); Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981). The House Report refers only to the majority approach. *See* HOUSE REPORT, *supra* note 18, at 10 & n.18.

49. The "majority approach" cases listed *supra* note 46 proceed from the assumption that the full range of common-law derivative liability is available in addition to § 20(a). These derivative theories by no means are limited to the employment relationship. *See* SEAVEY, *Speculations as to "Respondeat Superior,"* in HARVARD LEGAL ESSAYS 433 (1934).

50. In such a vicarious liability situation, the firm is the purchaser or seller. Thus, if knowledge of the information is imputed to the firm, as it normally will be, the firm would be trading "while in possession of" the material information.

51. *See* HOUSE REPORT, *supra* note 18, at 10-11. In such an obvious case company or firm liability would be based on something more than failure to supervise. In determining whether to impose *criminal* liability on a firm for the acts of its employees, assessing the level of senior management involvement may be proper. *See* Standard Oil Co. v. United States, 307 F.2d 120 (5th Cir. 1962); MODEL PENAL CODE § 2.07(1)(c) (Proposed Official

knows the information—for example, a trader in a firm's arbitrage department who has received a tip about an impending tender offer and trades on the firm's behalf. Early in the legislative history, the SEC indicated that it could seek a penalty against the firm in such an instance, although the circumstances might be such that a penalty substantially less than treble profits would be appropriate.[52] Other portions of the legislative history suggest that imposing firm liability based on a junior employee's actions may be the proper approach. For example, the legislative history expresses the need to prevent multiservice firms from facing penalty liability when one branch of the firm possesses material nonpublic information about a company and, without any communication, another branch buys or sells stock of the company for the firm's account—the "Chinese Wall" problem.[53] The Senate version of the bill had a statutory exemption from secondary liability for multiservice broker-dealers in such instances. The exemption was dropped at the last minute, but only on the expectation that the SEC would act to provide protection for such firms administratively, presumably through rulemaking similar to that found in rule 14e-3.[54] If a firm is not liable unless one or more members of the senior management both know the information *and* direct or authorize the trading, then the "Chinese Wall" problem would rarely, if ever, arise. Continuing concern over this issue, therefore, suggests that at least some of the drafters believed that a firm could face liability even though its upper level management was not simultaneously aware of the information and involved in the trade.

Draft 1962). *But see* St. Johnsbury Trucking Co. v. United States, 220 F.2d 393 (1st Cir. 1955).

52. *See House Hearings*, *supra* note 18, at 44. This assertion was based on a version of the bill that did not contain exemptive language for "secondary" participants. In its June 29, 1983, letter supporting modification of the bill to exempt nontipper-traders, the SEC stated that "where a person neither *shares in the illicit profits* of the inside trader nor tips such a person, the rationale of the bill does not apply," indicating that the SEC still viewed the firm as potentially liable when the trading was for its account. HOUSE REPORT, *supra* note 18, at 28-29 (emphasis added).

53. *See* HOUSE REPORT, *supra* note 18, at 11. A common example of the problem occurs when a firm's investment banking branch possesses the material information and the firm's trading department coincidentally trades that company's stock.

54. 130 CONG. REC. S8913-14 (daily ed. June 29, 1984) (remarks of Sen. D'Amato). The SEC had urged this rulemaking approach. *See House Hearings*, *supra* note 18, at 44-45. Rule 14e-3(b) exempts firms from liability to the extent they implement reasonable procedures to prevent the misuse of nonpublic tender offer related information. Section 21(d)(2)(A) gives the SEC rulemaking authority to "exempt from the provisions of this paragraph any class of persons or transactions."

Other parts of the legislative history, however, indicate that firm liability should not be predicated on a junior employee's unguided actions. In describing the situations in which corporate liability is appropriate, the House Report implies that direction by senior management is crucial to liability.[55] Moreover, one of the bill's sponsors clearly stated that "[i]f an investment adviser to an investment company, without the company's knowledge or approval, directs trades on behalf of the investment company while in possession of material nonpublic information, the investment company and consequently its shareholders should not be subject to the triple penalty."[56] By analogy, neither should the employer firm's shareholders, and on balance, this is the more sensible approach. The only deterrence-type justification for imposing penalty liability on a firm is that it may cause employers to take stronger steps to assure that their junior level employees do not trade on its behalf while possessing confidential information. While this watchfulness might be helpful, the legislative history shows no desire to extend liability to that level of "fault." To the contrary, the new Act itself specifically exempts employer liability based simply on failure to supervise.[57] The only difference is that the firm has benefited from the illegality, but this is remedied by making the firm disgorge the improper profits.[58] From a policy perspective, a firm should face liability for treble profits only if some or all of its senior management knew of the inside information and either caused or knowingly permitted the trade to take place for its own account.

3. Aiding and Abetting

The first sentence of section 21(d)(2)(B) states that no person shall be subject to civil penalty "solely because that person aided and abetted a transaction covered by such paragraph in a manner other than by communicating material nonpublic information."[59] The intent of this sentence is clearly to assure that only tippers

55. HOUSE REPORT, *supra* note 18, at 10-11.

56. 130 CONG. REC. H7758 (July 25, 1984) (statement of Rep. Dingell).

57. *See supra* note 44.

58. The junior-level employee is the primary wrongdoer and should be subject to penalty—his conduct is the functional equivalent of a tip. He could be found to be a primary violator or an aider and abettor of the firm's violation. In the latter characterization, however, the junior-level employee will be liable for the penalty only if his conduct included communication of information. *See* text accompanying note 59. To the extent that common-law imputation of knowledge is deemed "communication," that standard would be met.

59. Securities Exchange Act of 1934, § 21(d)(2)(B), Pub. L. No. 98-376, 98 Stat. 1264 (1984) (to be codified at 15 U.S.C. § 78u(d)(2)(B) (Supp. 1984)).

and traders, and not such persons as brokers who execute the unlawful trades, are subject to the penalty.[60] The drafters expressed the view that other remedies, particularly administrative proceedings under section 15(b), provide sufficient deterrence to broker misconduct.[61] Nonetheless, in explaining this exemption, the House Report gratuitously noted that "[t]he Committee endorses the judicial application of the concept of aiding and abetting liability to achieve the remedial purposes of the securities laws," and cited two Second Circuit cases with approval.[62] Plaintiffs certainly will try to use this language to support the expansive use of aiding and abetting liability in cases having nothing to do with insider trading.

III. Unlawful Trading

A. *Background*

The foregoing discussion shows that the Insider Trading Sanctions Act itself, while raising some interesting interpretive issues, is not difficult to understand.[63] More intriguing is the Act's spillover effect on the issue of what constitutes unlawful trading. As was observed earlier, the Act is to some extent a ratification of current insider trading doctrine. This is not to say that each and every previously decided case is approved of, but rather that the bill's drafters believed that the prevailing law in general provides an acceptable structure to carry out the objective of deterring abusive trading. Again, Congress would not have effectively quadrupled the penalties for insider trading had they been wholly dissatisfied with the underlying approach to the imposition of liability.

As submitted, the SEC draft bill carefully avoided defining insider trading. In a subsequent letter to House subcommittee Chairman Wirth, the Commission said that "[t]he flexibility which is gained by basing the imposition of the penalty on existing case law avoids the problems of freezing into law either a definition which is

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60. House Report, *supra* note 18, at 10; *see House Hearings*, *supra* note 18, at 44, 47-49 (SEC letter and testimony).

61. *See* House Report, *supra* note 18, at 28 (SEC letter).

62. House Report, *supra* note 18, at 10 n.17, (citing SEC v. Coven, 581 F.2d 1020, 1028 (2d Cir. 1978), *cert. denied*, 440 U.S. 950 (1979); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978)). Both of these cases represent a flexible, nonrestrictive approach to aiding and abetting liability.

63. Whether the Act will have its desired deterrent effect is an entirely separate question. Arguably, a step-up in criminal enforcement satisfactorily creates a substantial penalty threat; those who continue to trade unlawfully presumably believe that they will not be caught and are not terribly concerned with any threat.

too broad, or too narrow to deal with newly emerging issues."[64]

The House Report concurred, stating that the law "is sufficiently well-developed at this time to provide adequate guidance" and that:

> [t]he legal principles governing the majority of insider trading cases are well-established and widely-known. . . . Recent action by the Commission and the courts has clarified the legal principles governing the smaller number of cases that involve trading on information that originates from sources other than the company—for example, information about a future tender offer.[65]

On the Senate side, subcommittee Chairman D'Amato was not as convinced. In the course of the April 1984 hearings, he expressed the view that certain aspects of liability were highly uncertain and could result in a variety of abusive practices remaining unpunished. Senator D'Amato drafted a provision that would penalize a trader "if he employs the [material nonpublic] information in violation of his own fiduciary or contractual obligations, or if to his knowledge the information is imparted to him in violation of the fiduciary or contractual obligations of the person imparting such information to him."[66] This proposal provoked a substantial amount of controversy, and many influential persons submitted alternative proposals,[67] leading the SEC's general counsel to comment that drafting a substantive prohibition was becoming one of Washington's leading "cottage industries."[68] Recognizing that the inability to agree on either the need for a specific prohibition or how it should be drafted was the single remaining roadblock to the bill's passage, Senator D'Amato dropped the effort in June in order to assure prompt enactment.[69]

B. *The Basic Prohibition: Insiders*

The legislative history of the Act demonstrates that the drafters accepted the fiduciary duty basis for the obligation to abstain or disclose, established in *Chiarella* and reaffirmed in *Dirks*, as the starting point for analysis. In other words, a person must refrain from trading on inside information *if* he owes a fiduciary duty of

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64. HOUSE REPORT, *supra* note 18, at 32. *See generally* Junewicz, *Insider Trading Act Is Needed, but Without Defining the Term,* NAT'L L. J., Apr. 30, 1984, at 24, col. 3.

65. HOUSE REPORT, *supra* note 18, at 13 & n.20.

66. *See Senate Hearings, supra* note 20, at 32-35.

67. *Id.* at 8-10.

68. *Id.* at 37. Both the House and Senate hearings included fiduciary liability proposals, the most significant of which was that of Milton Freeman. *See* Freeman, *The Insider Trading Sanctions Bill—A Neglected Opportunity,* 4 PACE L. REV. 221 (1984).

69. 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

disclosure to the class of marketplace traders who are disadvantaged by not knowing those facts.[70] A person owes a fiduciary duty to investors in the securities of the issuer if he is a fiduciary of the issuer. Corporate directors, officers, and employees are the most obvious class of corporate fiduciaries, but as the *Dirks* case points out, there is a category of "temporary" insiders that includes attorneys, accountants, underwriters, and other agents, who owe common-law fiduciary obligations of loyalty and care to the issuer during the course of the relationship.[71]

The post-*Chiarella* case that tests the outer limits of the concept of fiduciary liability is *SEC v. Lund*.[72] In *Lund* the district court held that the defendant became a "temporary insider" of the issuer because the issuer's president, who was the defendant's friend and long time business associate, called the defendant, informed him of a lucrative joint venture that the issuer was planning, and asked the defendant if his company might be interested in a capital investment in the project. No corporate investment was made, but the defendant did purchase shares of the issuer on the basis of the disclosed information. The court held that the defendant became a temporary insider because the venture information had been made available to him "solely for corporate purposes," with the implication that it was to be kept confidential.[73]

The *Lund* decision is largely inconsistent with the recent *Dirks* case. In *Dirks*, the Supreme Court explicitly rejected the notion that fiduciary responsibility can arise simply from the receipt of confidential information, absent either some manifestation of assent by the outsider to some fiduciary obligations or participation in a breach of fiduciary duty creating tippee status.[74] Neither assent nor breach was present in *Lund*.[75] Though well-intended,

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70. *See* Langevoort, *supra* note 7, at 18-24; *see also* Anderson, *Fraud, Fiduciaries and Insider Trading*, 10 HOFSTRA L. REV. 341 (1982); Farley, *A Current Look at the Law of Insider Trading*, 39 BUS. LAW. 1771 (1984); Wang, *Recent Developments in the Federal Law Regulating Stock Market Insider Trading*, 6 CORP. L. REV. 291 (1983). A useful statement of the post-*Dirks* law of insider trading is the Report of the Task Force on Regulation of Insider Trading, submitted to the American Bar Association's Federal Securities Law Committee (discussion draft, Oct. 30, 1984).

71. Dirks v. SEC, 103 S. Ct. 3255, 3261 n.14 (1983); *see also* Langevoort, *supra* note 7, at 20-21 (examples of situations in which agents would be "temporary" insiders).

72. 570 F. Supp. 1397 (C.D. Cal. 1983).

73. *Id.* at 1403.

74. *Dirks*, 103 S. Ct. at 3261.

75. In the words of the *Dirks* Court, not only must there be an expectation of confidentiality, but "the relationship at least must imply such a duty." 103 S. Ct. at 3261 n.14. The outsider must manifest a willingness to act on the corporation's behalf rather than in

Lund's fiduciary duty holding is essentially contrary to a 1980 Second Circuit state law decision, *Walton v. Morgan Stanley & Co.*,[76] a case cited with apparent approval in *Dirks*.[77]

The above criticism notwithstanding, *Lund* is one of two cases cited explicitly in the House Report to support its conclusion that the current law is adequate to deal with basic "outsider trading" abuses.[78] There is no real indication that the drafters of the report were aware of the tenuous temporary fiduciary relationship basis for *Lund*. Nevertheless, the inclusion of the *Lund* citation gives some support to the argument of some of the Act's drafters that fiduciary responsibility should in some cases "run with the information." This use of *Lund* is a good illustration of a basic theme in the legislative history. While technically accepting the highly restrictive *Chiarella-Dirks* framework, the drafters' approach in discussing the substantive issues of liability seemingly eschews conceptualism—the legislative objective is to come down hard on any trading, as in *Lund*, that is inconsistent with basic notions of honesty and fair play. More important is deterring those who profit from the "theft" of information, not establishing a neat scheme for explaining coherently why such thefts violate the securities laws. One gets the sense that had the present Congress gone forward with a comprehensive definition of unlawful trading, it would not have chosen to follow the Supreme Court's restrictive approach that forces the sort of manipulation found in *Lund*.

C. *"While in Possession of"*

The language and legislative history of the Act appear to clarify one substantive issue that has arisen from time to time over the last few years. Section 21(d)(2) states that the civil penalty can be imposed on those who violate a rule or statutory provision barring trading "while in possession of" material nonpublic information.[79]

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pursuit of his own interests, at least with respect to the particular information.

76. 623 F.2d 796, 801 (2d Cir. 1980) (holding that participation in a confidential merger negotiation and receipt of sensitive information through those negotiations did not create a fiduciary obligation in the prospective merger partner).

77. *See Dirks*, 103 S. Ct. at 3265 n.22; *see also* Frigitemp Corp. v. Financial Dynamics Fund, 524 F.2d 275 (2d Cir. 1975) (finding no breach of fiduciary duty when outsiders had "constructive knowledge" of the information).

78. House Report, *supra* note 18, at 13 n.20. The citation in the report is to a preliminary decision in the case, SEC v. Lund, [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,428 (C.D. Cal., Jan. 22, 1982), which was followed in the later opinion.

79. Securities Exchange Act of 1934, § 21(d)(2), Pub. L. No. 98-376, 98 Stat. 1264, § 2 (1984) (to he codified at 15 U.S.C. § 78u(d)(2) (Supp. 1984)).

Commentators have questioned whether liability exists only when it can be shown that the information was the reason for the trading or whether it might be a defense if the insider can show that he would have traded anyway, with or without the information.[80] The 1984 Act's new statutory language suggests that the answer is no, that possession of the information, not motivation, is controlling. Further, a discussion in the course of the House hearings suggests that the drafters were aware of precisely what they were doing.[81]

D. *Trading in Options*

One substantive change that the Act explicitly creates is found in new section 20(d), which makes it unlawful to trade in options and other derivative instruments while in possession of material nonpublic information, whenever trading the underlying security would be unlawful. While prior to the 1984 Act, the issue was not totally resolved, a number of courts had held that because an option holder is not owed any fiduciary obligation by the corporation or its insiders per se,[82] the abstain or disclose rule is inapplicable to options trading.[83] This finding, of course, potentially allowed a major loophole in the law, for profits can be made as easily trading in options as in stocks.[84] Legislative revision was thus sensible,[85] although revision in the 1984 Act raises the same *Chiarella-Dirks* anomaly noted above. If we assume, as courts have, that option holders are not beneficiaries of any disclosure obligation as a matter of the law of fiduciary duty, the statutory change is effectively a statement that the disclosure obligation should exist, in some cases at least, absent any preexisting fiduciary duty. This extension is contrary to the *Chiarella-Dirks* rule that a preexisting duty is necessary, showing once again that while the drafters were prepared to

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80. *See* Langevoort, *supra* note 7, at 43-44.

81. *House Hearings*, *supra* note 18, at 48-49; *see* Stevenson, *supra* note 1, at 18, col. 4.

82. Because option holders own only a right to purchase an interest in a company, no fiduciary relationship between the company and the option holder exists prior to exercise of the option.

83. *See* Laventhall v. General Dynamics Corp., 704 F.2d 407 (8th Cir.), *cert. denied*, 104 S. Ct. 150 (1983); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981).

84. The options loophole is closed somewhat by an expansive use of the misappropriation theory, *see infra* notes 99-120 and accompanying text, or by rule 14e-3, which makes it a fraudulent act under section 14(c) of the Securities Exchange Act to trade while in possession of material nonpublic information concerning a tender offer. *See* O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. at 1187-1193.

85. *See* 130 CONG. REC. H7758 (daily ed. July 25, 1984) (statement of Rep. Dingell); 130 CONG. REC. S8913 (daily ed. June 29, 1984) (statement of Sen. D'Amato).

recognize and ratify the Supreme Court's approach in construing current law, they believed that from a policy standpoint it can result in too narrow a prohibition.

E. Tippers and Tippees

In *Chiarella*, the Supreme Court was forced to explain why, if a preexisting fiduciary relationship is necessary to invoke the abstain or disclose rule, tippees could ever be liable under that theory. The Court explained by stating that "[t]he tippee's obligation has been viewed as arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."[86] Apparently then, a breach of fidicuiary duty by an insider is a necessary precondition to tippee liability.

The *Dirks* case further explored this issue. In *Dirks*, an investment analyst was visited by two corporate insiders of a company that was fraudulently concealing its true condition. The insiders wanted the analyst to help them expose the misconduct. He did, but not before tipping his clients to sell their shares in that company. The Court's decision rigorously adhered to the fiduciary duty approach, holding that since the insiders had breached no duty to the company in trying to expose the fraud, the analyst had no derivative duty to disclose the information to other investors.[87] The fact that the analyst's clients profited vis-a-vis the rest of the market from access to information directly from inside the company was not enough. Whether or not one agrees with this holding, it was predictable in light of the Court's *Chiarella* construct. What is more significant about the decision is that the Court, going beyond the missing duty element and discussing extensively the scienter issue for tippee liability, added a new element to the law. Not only must there now be proof of a breach of fiduciary duty by the insider, but there also must be a showing that the tippee "knew or should have known of the breach," and to establish this element, the plaintiff must prove that the tippee was on notice that the insider would benefit personally from the tip.[88]

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86. *Chiarella*, 445 U.S. at 230 n.12; *see* Langevoort, *supra* note 7, at 25, 28-31. Strangely, new § 21(d)(2)(B) seems to indicate that tipping is unlawful because it aids and abets the trading—reversing the Court's emphasis.

87. *Dirks*, 103 S. Ct. at 3263-64.

88. *Id.* at 3265-66. On this point, the Court cited Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1978). For discussions of *Dirks*, see Phillips, *Insider Trading Liability After* Dirks, 16 REV. SEC. REG. 841 (1983); *The Supreme Court, 1982 Term*, 97 HARV. L. REV. 70, 286 (1983); Note,

This benefit requirement is a curious and largely unnecessary wrinkle; if there is one clear understanding in the common law of fiduciary responsibility, it is that an intent to benefit is not a necessary element. Moreover, the Court's approach to what constitutes a benefit is so broad that it makes the limitation extremely subjective and largely illusory. For example, the Court suggested that a tip designed to enhance the insider's reputation would be one for personal benefit.[89] More surprisingly, the Court indicated that a "gift" of confidential information would violate the rule because it resembles "trading by the insider himself followed by a gift of the profits to the recipient."[90] To define personal benefit to include the warm glow arising from "charitable" giving reduces the concept to an absurdity.[91]

The personal benefit prong developed in *Dirks* has had its effect. In *SEC v. Switzer*,[92] a corporate insider, attending a track meet, mentioned to his wife that there might be a liquidation of his company. This remark was "inadvertently overheard" by University of Oklahoma football coach Barry Switzer, who thereupon bought shares of the company. The district court concluded: first, that the insider breached no duty in mentioning the information to his wife; and second, that even had there been a breach, it was not manifestly for an improper purpose.[93] The first of these conclusions is not obvious—talking freely about a highly sensitive corporate matter at a track meet certainly can be a violation of the duty of care owed by a fiduciary. Still, the result is consistent with the strict logic of *Chiarella* and *Dirks*, for it is difficult to see that Switzer was actually a participant or co-venturer in the breach. Using this approach, the courts are saying that there is nothing wrong

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Rule 10b-5 and the Fiduciary Doctrine: Dirks v. SEC, 4 J. L. & COMM. 127 (1984); Note, *Securities:* Dirks v. SEC—*When Insiders Talk, Should You Listen?*, 37 OKLA. L. REV. 194 (1984); Comment, Dirks v. SEC: *New Guidelines for Tippee Liability Under Rule 10b-5*, 4 PACE L. REV. 631 (1984).

89. *Dirks*, 103 S. Ct. at 3266.

90. *Id.*

91. This amorphous view of benefit is particularly ironic insofar as the Court's purpose in establishing the personal benefit requirement is to restrict liability to those instances in which the tippee can readily ascertain the breach.

92. [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,589 (W.D. Okla., June 29, 1984).

93. *Id.* at ¶ 99,020. For other cases dealing with the benefit requirement, see State Teachers Retirement Bd. v. Fluor Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 91,656 (S.D.N.Y., Aug. 27, 1984); *In re* Wentz, [1984 Transfer Binder] FED. SEC. L. REP. ¶ 83,629, at 86,868-69 (Admin. Proc., May 15, 1984).

with a true outsider "getting lucky."[94]

Dirks was decided just before the House Committee acted on the insider trading legislation, and caused the committee some concern. The committee determined, however, that "if the *Dirks* decision is properly and narrowly construed by the courts, the SEC's insider trading program will not be adversely affected."[95] The House Committee did request the SEC to report periodically with an analysis of the case's effect. This legislative history should encourage courts to find that the benefit test presumptively is met whenever information is conveyed knowingly to an outsider without apparent business justification.

Even a narrow construction of the *Dirks* approach leaves open one important problem. Imagine that a financial analyst or newspaper reporter has arranged a meeting with a corporate executive to discuss various investment related matters. During the conversation, the executive releases some previously confidential information, in an effort to publicize it. May the analyst or reporter trade prior to "effective dissemination"? Following *Dirks* strictly, there was no apparent fiduciary breach by the executive because the release of the information was for a valid business purpose. The answer, however, is not so clear. Conceivably, in the analyst case at least, a court might find it improper for the executive to have disseminated the information "selectively," rather than at a press conference, thereby favoring one group of shareholders, through their agent, over others.[96] This improper disclosure would satisfy the first prong of the *Chiarella-Dirks* test by establishing a breach of fiduciary duty. If the selective disclosure appears to have been for the executive's reputational or other benefit, the second prong of the test would be met as well. Such a holding would require an insider to act with loyalty and care not only with respect to the *reasons* for communicating sensitive information but in the

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94. Insofar as the Act's legislative history expresses an intention to punish the "theft" of information, or situations of dishonesty or unfair dealing, the *Switzer* holding is judicially consistent. Certainly, allowing someone like Switzer to profit from his good fortune hardly will undermine investor confidence in the stock market.

95. HOUSE REPORT, *supra* note 18, at 14-15.

96. For the difficulties in applying *Dirks* in an investment analyst case, see *In re* Wentz, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,629 (Admin. Proc., May 15, 1984). In the case of a reporter, the misappropriation theory discussed below would provide an alternative method for imposing liability. *See infra* text accompanying notes 99-120. Similarly, under broad acceptance of the theory established in *Lund*, a court might consider the analyst a "temporary insider" to the extent that he received the information for a limited purpose. *See supra* notes 72-78 and accompanying text. Such an application of the *Lund* case merely highlights the conceptual difficulty of its theory.

method of communication as well. One should note, however, a statement by the House drafters that "[w]e anticipate that the courts . . . will be mindful of the necessity, in light of the substantial penalties herein imposed, to avoid unduly inhibiting traders from generating and acting upon valid research information of the sort upon which efficient markets necessarily depend."[97] Given the difficulty, if not impossibility, of distinguishing clearly between basic research efforts and eliciting useful information,[98] courts may be tempted to treat this legislative language as providing a safe harbor for analysts. Such a restrictive approach would be unfortunate, for one hardly can imagine a more vivid example of "unfair play" in the marketplace than the analyst/reporter example given above.

F. *Misappropriation*

One of the more indirectly significant aspects of the *Chiarella* decision was its failure to reject[99], and concurring comments from Justice Stevens seemingly in support of[100], the "misappropriation" theory of insider trading liability. The misappropriation theory, which holds that converting confidential information for personal trading gain operates as a fraud on the source of the information—usually the trader's employer—[101] was adopted quickly by the SEC as part of its enforcement program,[102] and received a

97. 130 CONG. REC. H7758 (daily ed. July 25, 1984) (statement of Rep. Dingell).

98. This point was first made in *Dirks. See* 103 S. Ct. at 3263 nn.17-18. The Court seems to have overstated this point; taken to its logical conclusion, any investment analyst would be free to tip or trade. *Cf.* Schein v. Chasen, 478 F.2d 817, 822-23 (2d Cir. 1973), *vacated on other grounds sub nom.*, Lehman Bros. v. Schein, 416 U.S. 386 (1974) (the first case to develop the "co-venturer" theory of tippee liability ultimately adopted in *Chiarella*); Langevoort, *supra* note 7, at 29 & nn.115-17; *see also* SEC v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977). For a case picking up on the Court's point, see Levinson v. Basic Inc., [Current] FED. SEC. L. REP. ¶ 91,801, at 90,045-46 (N.D. Ohio, Aug. 3, 1984); for a discussion of the investment analyst problem generally, see Comment, *An Examination of Investment Analyst Liability Under Rule 10b-5*, 1984 ARIZ. ST. L.J. 129.

99. *Chiarella*, 445 U.S. at 236-37.

100. *Id.* at 237-38.

101. The misappropriation theory is in distinct contrast to the rationale suggested by Chief Justice Burger in his dissent in *Chiarella*, 445 U.S. at 240-43. Burger's theory is that a person who misappropriates information comes under a duty to disclose the information to anyone with whom he trades. This theory has not received affirmative judicial recognition. *See* Moss v. Morgan Stanley Inc., 719 F.2d 5, 16 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1280 (1984).

102. No person will have a private right to sue nnder the misappropriation theory because, while the source of the information is deceived, it is not a purchaser or seller of the securities and has no standing to sue. *See* Moss v. Morgan Stanley Inc., 719 F.2d at 16; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754 (1975).

prompt judicial stamp of approval by the Second Circuit in *United States v. Newman.*[103] The misappropriation theory has become the primary vehicle for reaching nontraditional trading cases, those that are neither clear cut insider or tippee cases, nor proscribed explicitly by rule 14e-3.

There are two serious conceptual problems with this theory, both concerning consistency with the Supreme Court's 1977 decision in *Santa Fe Industries v. Green.*[104] The lesser difficulty is figuring out how merely using confidential information as the basis for trading is actually *deceptive*, rather than merely a breach of fiduciary duty—a requirement established by *Santa Fe.*[105] The more substantial problem is determining how a doctrine whose functional effect is to safeguard an employer's "confidentiality" interest fits within the "zone of interests" of the securities laws.

The legislative history of the 1984 Act evidences that the drafters were quite familiar with the misappropriation theory. The House Report cited *Newman*, for example, in support of its conclusion that the current law deals adequately with basic outsider trading abuses.[106] The SEC repeatedly espoused the theory for illustrative purposes in its statements and in House testimony for enhanced enforcement powers.[107] The Senate gave the misappropriation theory even more detailed consideration. Senator D'Amato raised questions about the viability of the misappropriation approach under current law, and justified his effort to include a definition of unlawful trading, which in many respects would simply have been a codification of the theory, by arguing the need to ensure that misappropriators are punished.[108] The SEC agreed that the theory was not solid law absent affirmative endorsement by the Supreme Court, but nonetheless resisted the effort to define unlawful trading, feeling "not dissatisfied," at least, with the use of the theory.[109] Although Senator D'Amato's decision to drop the definition was an attempt to expedite passage of the legislation, there is no evidence that he was convinced that a defi-

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103. 664 F.2d 12 (2d Cir. 1981); *see also* SEC v. Materia, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,681 (2d Cir. Oct. 1, 1984).

104. 430 U.S. 462 (1977); *see* Langevoort, *Fraud and Deception by Securities Professionals*, 61 TEX. L. REV. 1247, 1286-87 (1983); Langevoort, *supra* note 7, at 45-49.

105. 430 U.S. at 473-74.

106. HOUSE REPORT, *supra* note 18, at 13 n.20.

107. *See* SEC Proposal, *supra* note 17, at 22 n.34; HOUSE REPORT, *supra* note 18, at 32 (SEC letter); *House Hearings*, *supra* note 17, at 36.

108. *Senate Hearings*, *supra* note 20, at 32-33.

109. *Id.* at 33.

nition would either be unwise or unnecessary, his floor statement referred in approving terms to the misappropriation approach.[110]

Unquestionably, the legislative history reflects a congressional endorsement of the misappropriation theory, whatever its doctrinal uncertainty. There is repeated evidence from both sides of Congress that the principal drafters considered trading on "stolen" information an abuse that ought to be remedied.[111] Had there been a consensus that the current law does not reach such trading, clearly Congress would have attempted to cure the defect. Their failure to recognize a pressing need for a new definition of unlawful trading strongly suggests a "congressional intent" in favor of the misappropriation theory's validity as a general matter.

Simply recognizing the congressional ratification of the misappropriation theory, however, does not provide specific guidance for its application. First, what constitutes a "misappropriation"? Under *Santa Fe*, there must be deception for a cause of action under section 10(b).[112] In *Newman*, there was plain evidence of an active scheme by defendants to prevent detection—among other things, the use of secret foreign bank accounts. The court found this scheme, coupled with the harm the defendants caused by "sullying the reputations" of their investment bank employers[113] sufficient to establish fraud within the meaning of rule 10b-5.[114] Subsequent misappropriation cases have not been even that analytical, imposing liability for little more than trading on information when it seems clear that the trader's employer or client would object to such use.[115] This type of "deception," of course, is close to a simple breach of fiduciary duty. Nonetheless, the Act's legislative history evidences that the latter situation is precisely what the drafters believed should be covered by the insider trading laws, the "theft" of information. One suspects that this may be one more example of

110. 130 CONG. REC. S8912 (daily ed. June 29, 1984) (statement of Sen. D'Amato) ("I recognize the difficulties attendant to the codification of a definition applicable to the diverse circumstances governed by existing case low [sic], including . . . the respective rights of . . . sources of misappropriated information.")

111. *See Senate Hearings*, *supra* note 20, at 1 (Senator D'Amato stating insider traders are "thieves.").

112. 430 U.S. at 473-74.

113. This is a strange sort of harm, for it only occurs if the scheme is discovered.

114. *Newman*, 664 F.2d at 14-16. Of course proof of harm does not, in and of itself, distinguish deception from breach of duty.

115. *See* SEC v. Materia, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,681 (2d Cir. Oct. 1, 1984); SEC v. Musella, [1983-84] FED. SEC. L. REP. (CCH) ¶ 99,637 (S.D.N.Y., Jan. 14, 1984). *Musella* is also interesting because it imports the *Dirks* "benefit" test to the misappropriation context.

a congressional judgment that calls into question the wisdom of the Supreme Court's strict literalism.

The second conceptual issue is how can the breach of an employer's confidentiality interest be considered "in connection with the purchase or sale" of securities.[116] From a standpoint of conceptual neatness, a statutory provision that prohibits fraud and deception in connection with a purchase or sale of securities should require a showing that the person allegedly defrauded was engaged in some investment related activity in order to establish liability.[117] In *Newman*, there was a reasonable connection between the interests of defendants' employers and their clients, who needed confidentiality in order to assure the success of their merger related stock purchase program, and the objectives of the securities laws. The court's reasoning, however, was far broader, essentially finding that the "in connection with" requirement was satisfied by defendants' own trading, and thus moving the focus completely away from the defrauded parties' interests.[118] Once this step is taken a court may give a wide scope to the misappropriation theory, for by definition there always will be trading by the defendant. This doctrinal invention formed the basis of the recent action against a *Wall Street Journal* reporter, who purportedly joined with some associates in a scheme of trading based on prepublication information in the *Journal*'s "Heard on the Street" column. The SEC's complaint alleged that the reporter misappropriated this information "for his own direct and indirect personal benefit in breach of a duty to the Journal."[119] If one were to ask the *Journal* why it felt aggrieved by the reporter's actions, it likely would respond that its journalistic integrity, largely a reputational interest, was threatened. An injury to reputation is harm, of course, but is it really the kind of harm the securities laws were designed to protect against?

The short response to all these conceptual difficulties is that the misappropriation theory may be an ill-fitting invention, but the result it achieves-impo-sing a measure of fair play in the mar-

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116. 15 U.S.C. § 78j(b) (1982).

117. *See* Langevoort, *supra* note 104, at 1277-78, 1287.

118. *Newman*, 664 F.2d at 17-19.

119. SEC v. Brant, [1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,483 (May 17, 1984) (litigation release). Subsequently, a federal grand jury indicted the reporter for his actions, which has caused some media groups to question whether the prosecution may threaten first amendment interests. *See Ex-Reporter Indicted for Insider Trades; Novel 'Duty to Readers' Theory Included*, 16 SEC. REG. & L. REP. (BNA) No. 35, at 1445 (Aug. 31, 1984).

kets that was lost in the doctrinal rigidity of *Chiarella*'s abstain or disclose approach—accords with the investor confidence building intent of the securities laws generally. To the drafters of the Act, this goal seemed far more important than conceptual consistency. Indeed, the *Journal* case was cited a number of times in the legislative history as an example of the type of abuse that must be penalized.[120]

IV. Conclusion

The legislative history of the Act shows that its principal drafters regarded those who trade on material confidential information as "thieves," deserving substantial penalties. The adoption of the Act is an expression that the existing laws should be used aggressively to curb the misuse of information. Unfortunately, such a result-oriented direction fits uncomfortably within the confining conceptual structure for rule 10b-5 built in recent years by the Supreme Court. Lower courts therefore must flesh out the law of insider trading based on inconsistent mandates, which will make the future path of the law both unpredictable and interesting.

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120. *See* 130 Cong. Rec. H7757 (daily ed. July 25, 1984) (statement of Rep. Dingell); *Senate Hearings*, *supra* note 20, at 2, 37.

Besides approving of the misappropriation theory, the legislative history also reflects an endorsement of rule 14e-3. Rule 14e-3, upheld by a district court in O'Connor v. Dean Witter Reynolds & Co., 529 F. Supp. 1179, 1189-93 (S.D.N.Y. 1981), is not without some question concerning its validity. *See* Poser, *Misuse of Confidential Information Concerning a Tender Offer as a Securities Fraud*, 49 Brooklyn L. Rev. 1265, 1285-86 (1983); Note, *Trading on Material Nonpublic Information Under Rule 14e-3*, 49 Geo. Wash. L. Rev. 539 (1981). Plainly, the drafters were supportive of the rule, assuming its validity as a basis for their belief that the current law is largely adequate to reach most abuses. *See* House Report, *supra* note 18, at 13 n.20.