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LIABILITY FOR INSIDER TRADING: EXPANSION OF LIABILITY IN RULE 10b-5 CASES

by

ARTHUR J. MARINELLI*

"All you have to do is raise your eyes up from your clients and books . . . and you will realize that we are facing a crises in this country of unacceptable behavior." 1

INTRODUCTION

The subject of insider trading 2 has received increased attention partly because of the rapid growth in the size and frequency of tender offers, and partly because of the perception that insider trading is on the rise. Legal actions have been brought against bankers, lawyers and arbitrageurs. The largest insider trading Securities and Exchange Committee (SEC) settlement involved Ivan F. Boesky, a well known arbitrageur who agreed to disgorge fifty million dollars in trading profits, and paid a civil penalty of fifty million dollars. Mr. Boesky also agreed to cooperate with the SEC in its investigations of others and was barred from ever working in the securities industry. Mr. Boesky entered a guilty plea to one felony charge and was sentenced to three years in jail. 3

The federal securities acts of 1933 and 1934 sought to protect the investing public against fraud and manipulation by replacing the doctrine of caveat emptor with a system of full disclosure. 4 Section 10(b) 5 of the Securities and Exchange Act gives the SEC broad powers to assure fairness and integrity in the stock market. 6 With the enactment of the Securities and Exchange Act and Section 10(b),

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2 Insider trading is the buying or selling of securities based on an illegal informational advantage. See 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD AND COMMODIES FRAUD § 7.4 (100) (Nov. 1984).


   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 for the protection of investors.

Congress intended to prevent all deceptive and manipulative practices, including those that would develop in future years. Although there is no language in either Section 10(b) or Rule 10b-5 which expressly provides for a private cause of action for damages, ever since the seminal case of *Kardon v. National Gypsum Company* courts have firmly established such a right. Rule 10b-5 was promulgated to cover sellers as well as buyers. Therefore, it appears that Congress intended to create a grant of rulemaking power that could reflect the changes taking place in securities markets in which "practices legitimate for some purposes may be turned to illegitimate and fraudulent means." The courts interpreted the rule liberally in the 1960's and 70's, reflecting the catchall function of both the section and the rule.

In *Capital Gains Research Bureau*, the Supreme Court indicated that Congress intended securities legislation to be construed flexibly to effectuate remedial purposes. It held in *Bankers Life and Casualty Co.* that the securities law should be read as broadly as necessary to achieve the underlying purposes of the 1934 Act. The great majority of scholars have agreed that the prohibition of insider trading is justified by the need to safeguard the fairness, confidence and integrity in the marketplace, to protect private investors, and to encourage investment in our securities markets. Some commentators, particularly Professor Manne, argue that insider trading is beneficial to corporate and market efficiency because information moves more quickly into the marketplace, restrictions on insider trading ignore objective goals of allocative efficiency, and investors would be better served if stock prices moved toward "true" values.

This article will examine the recent litigation developments of Section 10 and

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7 Thomas G. Corcoran speaking for the drafters of § 10(b) to the House Committee on Interstate and Foreign Commerce said "Section 10(b) says "thou shalt not devise any other cunning devices . . . [The Section] is a catchall clause to prevent manipulation devices . . . The commission should have the authority to deal with new manipulative devices." *Hearings on H.R. 7852 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d, Sess. II5 (1934); *See also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-03 (1976).
11 H.R. REP. NO. 1383, 73d Cong., 2d Sess. 6-7 (1934).
16 *See H. MANNE, supra*, at 32-41, 59-75, 99-103.
Rule 10-b in *Carpenter v. United States*\(^{17}\) and in *Basic, Inc. v. Levinson*.\(^{18}\) The origins and developments of the misappropriation theory and the application of the mail fraud statutes as applied to Section 10 will also be discussed. Finally, the duty of disclosure and the timing of disclosure of merger negotiations, along with the fraud-on-the-market theory of civil liability under Rule 10b-5, will be explored in the context of the *Basic* case.

The "misappropriation" theory of insider trading liability holds that it is a violation of the federal securities laws to trade securities based upon non-public information obtained by a person who is, by the position of employee or other position of trust, under a duty not to use such information for his own gain.\(^9\) The "fraud-on-the-market" theory of liability discussed in *Basic* in the context of a merger, involves permitting injured investors who do not rely directly on misinformation, but rely on the integrity of the market’s communication and pricing functions to recover.\(^{20}\)

**LIMITATIONS ON THE REACH OF RULE 10b-5**

Rule 10b-5 is a broad anti-fraud provision of the federal securities laws: it prohibits fraud, misrepresentation, half-truths, concealment of after-acquired information, and omissions.\(^{21}\) It applies to conduct including insider trading\(^{22}\), exchange and tender offers\(^{23}\), broker-dealer activities\(^{24}\), market manipulation\(^{25}\), and mismanagement.\(^{26}\) The statute of limitations under Rule 10b-5 is more favorable than other federal securities provisions since it is subject to the generous time periods of state statutes.\(^{27}\) Professor Bromberg estimates that Rule 10b-5 cases now

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\(^{21}\) These are common 10b-5 violations, SEC v. *National Bankers Life Ins. Co.*, 324 F. Supp. 189, 195 (N.D. Tex.), *aff’d*, 448 F.2d 652 (5th Cir. 1971).


represent nearly one-third of all cases brought under the securities statutes.\(^{28}\)

The early cases under Rule 10b-5 held that illegal conduct must meet the minimum common law requirements for fraudulent misdisclosure.\(^{29}\) Courts soon sought to develop fiduciary duties on corporate insiders through special facts or trusteeship doctrines to effectuate the goals of the securities legislation\(^{30}\) and the expansion of legal remedies. The meaning and scope of Rule 10b-5 has since been in a state of evaluation, and has been described as a “judicial oak which has grown from little more than a legislative acorn.”\(^{31}\) Courts have had few problems in applying Rule 10b-5 to corporate insiders, but have had difficulty with those individuals outside the corporate structure who can affect the securities marketplace.\(^{32}\) In 1961, the SEC in *In re Cady, Roberts & Co.*\(^{33}\) emphasized that Rule 10b-5 restricts the trading activities of “any person,” and is based on “the inherent unfairness involved where a party takes advantage of [information intended to be available only for a corporate purpose] knowing it is unavailable to those with whom he is dealing.”\(^{34}\) The list of insiders no longer need be a corporate official, director, or controlling shareholder; it is extended to “those persons who are in a special relationship with a company and privy to its internal affairs.”\(^{35}\) The Second Circuit reached the same conclusion in *SEC v. Texas Gulf Sulphur Co.*,\(^{36}\) holding that anyone in possession of insider information must either disclose it to the investing public or refrain from trading.\(^{37}\) With SEC support, the courts expanded the list of insiders and the transactions covered by Rule 10b-5, along with relaxed common law requirements for fraudulent nondisclosure.\(^{38}\) The courts extended “insiders” to include both tippers and tippees.\(^{39}\) Fairness has few bounds, and the Burger Court placed restrictions on Rule 10b-5, even though it had no


\(^{29}\) See, e.g., Birnbaum v. Newport Steel Corp., 193 F. 2d 461 (2d Cir. 1952) (holding Rule 10b-5 actions are limited to frauds traditionally associated with securities sales) cert. denied, 343 U.S. 956 (1953); Kardon v. National Gypsum Co., 73 F. Supp. 798, 802-03 (E.D. Pa. 1947) (court relied on principles governing fiduciary relationships to impose liability on corporate directors).

\(^{30}\) See *Kardon*, 73 F. Supp. at 803. In this case insiders (corporate officers and directors) failed to disclose material information while they purchased corporate stock. The court held that the officers had obligations similar to the fiduciary obligations of a trustee.


\(^{34}\) *Id.* at 912.

\(^{35}\) *Id.*

\(^{36}\) 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied sub nom., Coates v. SEC, 394 U.S. 976 (1969). The case centered on misleading press releases regarding minerals owned by Canadian land owners by the corporation.

\(^{37}\) *Id.* at 848.


\(^{39}\) See, e.g., Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228, 239-40 (2d Cir. 1974).
unified approach.\textsuperscript{40}

Among the elements necessary for recovery in a 10b-5 action is that the pro-
scribed activities must be “in connection with the purchase or sale of any securi-
ty.”\textsuperscript{41} If plaintiffs are neither purchasers nor sellers of the offered shares they will
not be able to recover.\textsuperscript{42} Before the plaintiff may prevail in a private action, he must
prove scienter on the part of the defendants,\textsuperscript{43} reliance,\textsuperscript{44} and causation in fact.\textsuperscript{45}
The standard of proof in civil actions under Rule 10b-5 is a preponderance of the
evidence.\textsuperscript{46} The SEC and the courts hold that tippees are liable under Rule 10b-5
because tippers are subject to the same duties as traditional corporate insiders by
reason of their special access to inside information.\textsuperscript{47}

In \textit{Chiarella v. United States}\textsuperscript{48} the Supreme Court considered the substan-
tive reach of Rule 10b-5. Reversing the Second Circuit’s decision,\textsuperscript{49} the Court held
that Chiarella’s conduct was not violative of Section 10b or Rule 10b-5 because
a duty to disclose before trading does not arise from mere possession of non-public
market information.\textsuperscript{50} Chiarella was a financial printer’s markup man and trad-
ed using material, non-public information entrusted to his employer.\textsuperscript{51} He was con-
victed of seventeen counts of willful violation of Rule 10b-5\textsuperscript{52}. Chiarella appealed
on the basis that he had no direct relationship with the issuers in whose stocks
he traded, and therefore, was an “outsider”.\textsuperscript{53} The Second Circuit affirmed his
conviction, holding that his egregious abuse of his “regular access to market in-
formation” made him a “quasi-insider”\textsuperscript{54} subject to the insider trading rules of
10b-5. The Second Circuit found that unfair trading took place where one had une-
qual access to material nonpublic information.\textsuperscript{55}

The Supreme Court reversed the lower court, Justice Powell, writing for the

\textsuperscript{40}See, e.g., Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977) (exchange offeror has no implied cause of
action against rival offeror), United Hous. Foundation Inc. v. Foreman, 421 U.S. 837 (1975) (shareholders
of stock in a nonprofit housing cooperative do not own securities and are not proper parties to a private suit);
Whitaker & Rotch, \textit{The Supreme Court and the Counter Revolution in Securities Regulation}, 30 ALA. L. REV.
335 (1979).

\textsuperscript{41}17 C.F.R. § 240, 10b-5 (1986).

\textsuperscript{42}See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

\textsuperscript{43}See Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

\textsuperscript{44}See, e.g., Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Rose v. A.H. Robbins Co., 607 F.2d 545


\textsuperscript{47}Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, 495 F.2d 228 (2d Cir. 1974).

\textsuperscript{48}445 U.S. 222 (1980).

\textsuperscript{49}588 F.2d 1358 (2d Cir. 1978), rev’d, 445 U.S. 222 (1980).

\textsuperscript{50}445 U.S. at 233.

\textsuperscript{51}Id. at 224.

\textsuperscript{52}Id. at 225, 236.

\textsuperscript{53}Id. at 232-33.

\textsuperscript{54}United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), rev’d, 445 U.S. 222 (1980).

\textsuperscript{55}Id. at 1365-66.
majority, stated that mere possession of material non-public information does not impose an obligation to disclose or a duty to refrain from trading. The Court rejected the lower court's delineation of the parameters of insider trading violations and found that "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud." The Court identified the district and circuit courts' error as their "failure to identify a relationship between petitioner and the sellers that could rise to a duty." The Court held that non-disclosure can be fraudulent only when there is a duty to speak, and that a relationship that gives rise to a duty to disclose must exist before Rule 10b-5 can be violated. The Court rejected the equal access approach of the lower courts and adopted the Cady, Roberts & Co. rules that a fiduciary relationship requirement exists between "shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." The majority never reached the claim that Chiarella's misappropriation of information from his employer sufficed for Rule 10b-5 liability because this theory was not presented to the jury.

The dissenting opinion of Chief Justice Burger would apply the disclosure or abstain rule "when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means... I would read 10(b) and Rule 10b-5... to mean that a person who has misappropriated non-public information has an absolute duty to disclose that information or to refrain from trading." While the majority did not address the appropriation theory because it was not part of the jury's instructions, Justice Brennan in his concurring opinion, and Justices Blackmun and Marshall in their dissenting opinion, "agree[d] with much of what [was] said" by the Chief Justice concerning the misappropriation theory.

The number and diversity of views stated by the Justices in Chiarella left open a significant number of issues, including: (1) is the misappropriation theory applicable to Section 10 actions; (2) do tippees who receive material nonpublic information from fiduciaries or in whom trust and confidence has been placed cause a violation; and (3) must there be a relationship of trust and confidence, and under what circumstances does such a relationship exist between parties to the securities transaction before a violation occurs?

56 Chiarella, 445 U.S. at 235.
57 Id. at 231-33.
58 Id. at 234-35.
59 Id. at 232.
60 Id. at 235.
61 Id. at 228.
62 Id. at 236-37.
63 Id. at 240.
64 Id. at 239 (Brennan, J., concurring).
65 Id. at 245.
Three years after Chiarella, in Dirks v. SEC, the Supreme Court reversed the lower court's judgment reasoning that the financial analyst's liability could only derive from a breach of fiduciary duty by his tipper. Because the tipper did not breach a duty to the shareholders, Dirks should not have been censured by the SEC. Further, the Court required that the tippee must know or have reason to know that the tipper has breached a fiduciary obligation by revealing the information. Finally, the Court held that an insider's tip constitutes a breach only if the insider receives a direct or indirect personal benefit. The Court reversed the conviction because Dirks did not have a duty to disclose information before trading. The insider from whom Dirks received the information did not breach a duty to the shareholders or the corporate employer because he had no motive for personal gain. Dirks did not himself own or trade Equity Funding stock during his investigation, but he shared his knowledge of fraud with some clients and investors who did sell the stock. The stock price declined significantly. Justices Brennan, Blackmun and Marshall dissented on the ground that the majority further limited Rule 10b-5's reach by "engraft[ing] a special motivational requirement on the fiduciary duty doctrine." In dictum, a majority of the Court accepted the misappropriation theory as adopted by the Second Circuit, stating that Dirks did not misappropriate or illegally obtain the information.

The Court in Chiarella and Dirks premised its holding on the rationale articulated by the SEC in the In Re Cady, Roberts & Co. case. In Cady, Roberts & Co., the SEC held that if an insider trades with material, inside information, a violation of Rule 10b-5 occurs because a relationship exists affording access to inside information intended for corporate purposes, and because it is unfair for the insider to take advantage of the insider information without disclosure. One of the most significant findings of the Court in Dirks was the fact that certain persons to whom corporate information is provided may become fiduciaries of the shareholders. These fiduciaries may include underwriters, accountants, lawyers, or consultants to the corporation. The concept of an insider is flexible, and the test is whether this information was intended to be available only for

67 Id. at 648-52.
68 Id. at 659-61. A "tipper" is an insider who passes secret information (a "tip" to an outsider, a "tippee").
69 Id. at 667.
70 Id. at 660.
71 Id. at 662.
72 Id. at 665-67.
73 Id. at 667.
74 Id. at 668.
76 Id. at 665.
78 Dirks, 463 U.S. at 655 & n.14.
a corporate purpose and not for the personal benefit of anyone.79

THE MISAPPROPRIATION THEORY: CARPENTER V. UNITED STATES80

The Chiarella and Dirks decisions limited liability by requiring that a person trading on the basis of inside information, breach a fiduciary duty owed either directly or derivatively. The duty owed derivatively may arise from being a tippee of an insider who breached his fiduciary duty, or by being a temporary insider by virtue of access to certain confidential information to be used for corporate purposes. The framework of Chiarella and Dirks leaves gaps in liability coverage. For example, trading in a target company’s stock with inside information may occur without a violation under 10b-5 because the traders owe no fiduciary duty to the company’s shareholders. The SEC and the Second Circuit have advocated a misappropriation theory to impose criminal and civil liability on non-traditional insiders and tippees. The theory was first advanced in Chiarella when it was argued that he breached a duty to the acquiring corporation by misappropriating information entrusted to his employer, and therefore fraud took place upon the entrusting corporate client and the sellers of the target companies securities.81 The majority did not believe the issue was properly before the Court because the theory had not been submitted to the jury.82 However, four Justices indicated varying degrees of acceptance of the misappropriation theory.83

In SEC v. Materia84 the Second Circuit held that Materia, a copyreader employed by a financial printer, had misappropriated confidential information concerning proposed tender offers of the printer’s corporate clients for the purpose of trading in the securities of the target companies.85 The court emphasized the damage to the reputation of the employer and the damage to the corporate clients because of the rise in the price of the target company’s securities.86 The court did not extend Materia’s duty to the sellers of the securities even though they had been damaged by his actions.87

In United States v. Carpenter,88 an equally divided Supreme Court affirmed the Court of Appeals for the Second Circuit that the conduct of Winans amounted

79 Feldman v. Simkins Indus., Inc., 679 F.2d 1299 (9th Cir. 1982).
82 Id. at 236-37.
83 Id. at 238-51.
85 See id. at 199-201.
86 Id. at 202.
to a violation of 10(b) of the Securities Exchange Act of 1934. In an unanimous opinion, the Court found that Winans' conviction should stand under the federal mail and wire fraud statutes, which prohibit the use of the mails to execute any scheme or artifice to defraud or obtain money or property by means of false or fraudulent pretenses, representations, or promises. The Second Circuit had significantly expanded the application of the misappropriation theory in Carpenter. A divided court of appeals affirmed the criminal conviction of Wall Street Journal financial reporter, R. Foster Winans, who was one of the writers of the widely-read "Heard on the Street" column. He provided Kenneth P. Felis and Peter Brant, stockbrokers at the brokerage house of Kidder Peabody, with the content and publication dates of certain columns of "Heard on the Street". Generally, Brant would learn of the subject of the article a day before publication from a call from Winans on a pay phone, and he in turn traded in the stock of the companies to be reported on in the articles. David Carpenter, a newspaper clerk at the Wall Street Journal, served as a messenger between the reporter and brokers. The Court found that both Winans and Carpenter were aware that they were using company property, and that non-public information was to be treated as confidential.

The district court pointed out that information contained in the "Heard" columns could have a real impact on the stock market. The court of appeals subsequently pointed out that this confidential information enabled the defendants to realize profits of approximately $690,000 through trading on the basis of the information obtained. The Kidder Peabody Compliance Department noticed the correlation between the trades in Felis's accounts and the information in the "Heard" columns. The defendants attempted to conceal their scheme from both Kidder Peabody and the SEC, and made false statements to agency officials. Eventually Winans and Carpenter voluntarily testified to the SEC and were convicted of securities fraud in violation of Section 10(b) and Rule 10b-5. Neither the Wall Street Journal nor its parent company engaged in securities trading or

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92 791 F.2d at 1026.
93 Id. at 1026.
94 Id. at 1027. The defendants made approximately twenty-seven trades on the basis of pre-publication information concerning the "Heard" columns.
95 Id. at 1026.
96 Id.
97 Winans, 612 F. Supp. at 830.
98 791 F.2d at 1027.
99 Id.
100 Id.
101 Id.
had corporate clients who were the source of information for the columns.\textsuperscript{103} Winans had not improperly altered the content of the columns, and the information was available to the public generally.\textsuperscript{104}

The Court of Appeals for the Second Circuit, in an opinion written by Judge Pierce, affirmed the convictions\textsuperscript{105} and acknowledged that Congress had given the judiciary the burden to determine whether a violation occurred in a particular case given the broad prohibitions in Section 10(b) of the 1934 Act.\textsuperscript{106} The Court found that the misappropriation theory could be the basis of a Section 10(b) violation if the defendants' unlawful misappropriation of material, non-public information from the \textit{Journal}, and its subsequent use of the information for their profit, was in connection with the sale or purchase of securities.\textsuperscript{107} The facts in the case rendered the fraud issue one of first impression. The Supreme Court had never precluded the lower courts from utilizing the theory of misappropriation in cases involving securities fraud.\textsuperscript{108} After \textit{Chiarella}, the Second Circuit used the misappropriation theory in \textit{SEC v. Materia}\textsuperscript{109} and \textit{United States v. Newman}.\textsuperscript{110} In \textit{Carpenter}, the defendants sought to distinguish previous misappropriation cases by arguing that the only breach was of the employer's confidentiality; there was no injury to the corporation or to the shareholders whose stock was sold or purchased on the basis of the confidential information.

The court of appeals found that the defendants' interpretation constituted too narrow a reading of previous misappropriation cases, and that the misappropriation theory prohibited conversion of non-public information by insiders and others.\textsuperscript{111} The court relied on statements that accompanied the Insider Trading Sanctions Act of 1984\textsuperscript{112} to determine congressional intent. The intent of the 1934 Act was to prohibit all manipulative or deceptive trading regardless of whether the information about the corporation or its securities came from inside or outside the corporation.\textsuperscript{113} While a person may gain knowledge about securities through skill or industry, such knowledge may not be gained through misappropriation of information from any employer in breach of a fiduciary duty of confidentiality.\textsuperscript{114} The fraud took place when Winans and Carpenter damaged the rep-
utation of the *Wall Street Journal* and used the information for their own profit.\textsuperscript{115}

In a strong dissent on the misappropriation theory, Judge Minor held that a newspaper’s publication schedule is not the type of securities related information to be used in the misappropriation theory.\textsuperscript{116} He found that mail and wire fraud were the appropriate offenses, rather than damage to reputation under the 1934 Act.\textsuperscript{117}

The misappropriation theory as applied to Carpenter and Winans has divided the Supreme Court. Only the future decisions of the Court will indicate the acceptance or rejection of the theory in securities fraud cases and possible limits of the theory. This sharp division of the Court is not surprising given the broad step that the court of appeals took away from *Chiarella*, where the Court held there was no general duty for disclosure unless there is a fiduciary duty with the shareholders: “we know of no rule of law . . . that a purchaser to stock, who was not an insider and had no fiduciary relationship to a prospective seller, had any obligation to reveal circumstances that might raise a seller’s demands and thus abort the sale.”\textsuperscript{118} In *Carpenter*, Winans owed no duty to shareholders because he had no relationship with the issuers of stock or the corporations whose information was reported on, whereas in prior misappropriation cases, there was a direct link between the misappropriator and corporate clients who were purchasing securities.\textsuperscript{119} It has been suggested that the misappropriation theory has been misapplied in *Carpenter* because it relies on damage to employers rather than placing the emphasis on protection of investors.\textsuperscript{120} It is unfortunate that the Supreme Court affirmed the conviction of Winans by a equally divided Court without an opinion on this issue. It has left open many unanswered questions concerning whether the misappropriation theory may be used in a situation like *Winans*.\textsuperscript{121} Congress has the opportunity to include it in new legislation being considered to expand the scope of Section 10(b) against insider trading.\textsuperscript{122}

Writing for a unanimous Supreme Court, Justice White found that petitioners’ conspiracy to trade on the *Wall Street Journal*’s confidential information is a violation of the mail and wire fraud statutes.\textsuperscript{123} The Court rejected any distinction between tangible and intangible property for purposes of the mail and wire fraud statutes, thereby providing clarification of *McNally v. United States*.\textsuperscript{124} The court

\textsuperscript{115}791 F.2d at 1032.
\textsuperscript{116}Id. at 1036 (Miner, J., dissenting).
\textsuperscript{117}Id. at 1037.
\textsuperscript{118}*Chiarella*, 445 U.S. at 232 & n.14 (quoting General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1968), cert. denied, 393 U.S. 1026 (1969)).
\textsuperscript{119}See Materia, 745 F.2d at 199-200; Newman, 664 F.2d at 16.
\textsuperscript{122}See Proxmire Plans Inquiry, N.Y. Times, Nov. 24, 1986, at D6, col. 6.
\textsuperscript{124}107 S. Ct. 2879 (1987).
rejected defendant's arguments that the mail and wire fraud statutes are limited to tangible property, and ruled that the scheme to defraud in using the Wall Street Journal's confidential information "has long been recognized as property" despite being of an intangible nature. The court reaffirmed a line of cases that has long held that confidential business information is property.

The Court used a two prong test to determine if the property is protected by the mail and wire fraud statutes. The confidential information must be generated from the business and the business must have the exclusive right to decide how to use the information: "exclusivity is an important aspect of confidential business information and most private property for that matter." The Court found that fraud was present: the concept of "fraud includes the act of embezzlement, which is the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another." Moreover, the Court held that an employee breached "a fiduciary obligation to protect confidential information obtained during the course of his employment." The specific intent to defraud, an essential element of the offense, was found in part from his telling the editors of the Wall Street Journal about leaks of confidential information not related to the stock-trading scheme. This demonstrated to the Court that he knew of the confidential nature of information concerning the "Heard" column and realized "his deceit as he played the role of a loyal employee." The wire and mail were used to send the Wall Street Journal to its customers and the "circulation of the "Heard" column was not only anticipated, but an essential part of the scheme." As well known securities lawyer Harvey L. Pitt was quoted after the decision in Carpenter, "It's a tremendous victory for the government. Most insider trading cases [that are worthy of criminal prosecution] can be brought as mail and wire fraud cases. I know of no [such] cases that can't go forward."

**Definition of Materiality and Fraud-on-the-Market in the Context of a Merger: Basic, Inc. v. Levinson**

The Supreme Court has resolved a number of unanswered questions and con-
flicts between circuits\textsuperscript{136} on the standard of materiality applicable to preliminary merger discussions, and in determining whether the courts below properly applied a presumption of reliance rather than requiring direct reliance on statements of a party to a merger.

The facts in Basic, Inc. involved protracted merger negotiations between Combustion Engineering, Inc. and Basic over a two year, three month period. While the merger negotiations were taking place, there were bouts of more active trading in Basic's shares, which were met with Basic's response that it was "unaware of any present or pending corporate development that would result in the abnormally heavy trading activity."\textsuperscript{137} The Sixth Circuit held that there may be no duty to disclose, but once disclosure is made, complete truth and accuracy must prevail.\textsuperscript{138} The court stated, "A statement that 'no negotiations' were occurring could reasonably be read to state that no contacts of any kind whatsoever regarding merger had occurred."\textsuperscript{139} The Sixth Circuit opinion rejected the holding in Hueblein\textsuperscript{140} that acquisition discussions or negotiations do not become material until there is an agreement in principle. This opinion may be interpreted as requiring affirmative disclosure of very early contacts.

The Supreme Court adopted the current standard of materiality in TSC Industries v. Northway, Inc.,\textsuperscript{141} which involved a proxy solicitation case. The Court concluded: "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."\textsuperscript{142} The Court went on to expressly adopt the language of TSC Industries on materiality: "[t]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."\textsuperscript{143} The Court recognized that application of this materiality standard is not self-evident given the contingent or speculative nature of preliminary merger negotiations. The Court rejected the Third Circuit's test defining the duty to disclose the existence of ongoing merger negotiations when an agreement in principle is reached.\textsuperscript{144} The Court found that the purposes of the securities acts were: "[d]isclosure, and not paternalistic

\textsuperscript{136} See Staffin v. Greenberg, 672 F.2d 1196 (3d Cir. 1982); Greenfield v. Heublein, Inc., 742 F.2d 751 (3d Cir. 1984), cert. denied, 105 S. Ct. 1189 (1985). Both Staffin and Greenfield adopted the "agreement in principle" test holding that merger negotiations are not material until an agreement in principle has been reached on fundamental terms including price and structure of the agreement. See the rejection of the "agreement in principle test" in Levinson v. Basic, Inc., 786 F.2d 741 (6th Cir., 1986), affirmed as to rejection of the agreement in principle test, 108 S. Ct. 978 (1988).

\textsuperscript{137} Basic, Inc., 786 F.2d 741, 745 (6th Cir. 1986).

\textsuperscript{138} Id. at 746.

\textsuperscript{139} Id. at 747.


\textsuperscript{141} 426 U.S. 438 (1976).

\textsuperscript{142} Id. at 449.

\textsuperscript{143} Id. at 449.

withholding of accurate information. . . .” 145 The Court clearly limited its decision to cases involving the accuracy and completeness of the disclosure and did not involve the timing of a disclosure.146

The general issue of the duty to make disclosure once merger negotiation begins must be left to later cases because the Court clearly refused to deal in this context with arguments based on “premature” disclosure.147 The Court again relied on its holding in TSC Industries by judging the test to be what reasonable shareholders would draw from a given set of facts and the significance of those inferences.148 The Court rejected not only the agreement-in-principle test, but also failed to adopt the Sixth Circuit’s language because it failed to recognize that the “plaintiff must show that the statements were misleading as to a material fact.” 149 The Court indicated that materiality is to be determined on the basis of the particular facts of each case and quoted with approval the late Justice Friendly regarding merger information: “[i]t can become material at an earlier stage than would be the case as regards lesser transactions . . . and this even though the mortality rate of mergers in such formative stages is doubtless high.” 150 The Court remanded the case for reconsideration of the question whether a grant of summary judgment is appropriate given the Court’s standard of materiality, which differed from the lower courts.

RELIANCE AND FRAUD-ON-THE-MARKET

Reliance is a necessary element in a Rule 10b-5 cause of action and provides the causal connection between the defendant’s misrepresentation and the plaintiff’s injury.151 The Supreme Court recognized that reliance is different in modern securities law where literally millions of shares change hands daily as opposed to face-to-face transactions. It stated: “Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.” 152 The lower courts had created a presumption that because of Basic’s material misrepresentation, the price of the stock had been fraudulently depressed. The presumption which could be rebutted by the petitioners was partly supported by the fraud-on-the-market theory and recognized the evidentiary burden on the Rule 10b-5 plaintiff who was trading in an impersonal market.153

145 Id. at 984.
146 Id. at 985.
147 Id.
148 TSC Indus., 426 U.S. at 450.
150 Id. at 987 (quoting SEC v. Geon Industries, Inc., 531 F.2d 39, 47-48 (2nd Cir. 1976)).
153 Id. at 990.
The fraud-on-the-market theory contemplates deception in impersonal transactions that injure investors who do not rely directly on misinformation, but rely on the market’s integrity as to price. The Court found that the presumption of reliance on the market is supported by common sense, probability, commentators, lower courts, and recent empirical studies. The Court of appeals finding that the fact that the petitioners “made public material misrepresentations and [respondent] sold Basic’s stock in an impersonal, efficient market was an important factual determination.” The Court placed limits on the fraud-on-the-market theory, indicating that any showing which severs the link between the alleged misrepresentation and the price paid or received, or the decision to trade in the stock, will rebut the reliance presumption. By giving examples of when the presumption does not occur, the Court shows that it is concerned with plaintiffs who do not rely on market prices in making their investment decisions, and encourages vexatious litigation which cannot properly be disposed of without a trial.

The dissent, written by Justice White and joined in by Justice O’Connor, agreed with the materiality standards of the majority opinion, but did not agree that the “fraud-on-the-market” theory should be applied in this case. The dissent approved the rejection by the Court of a broad “fraud-on-the-market” theory that would equate causation with reliance, permitting recovery by a plaintiff “who claims merely to have been harmed by a material misrepresentation which altered a market price, notwithstanding proof that the plaintiff did not in any way rely on that price.” The dissent agreed with the majority’s opinion that courts cannot allow recovery under a presumption if the evidence rebuts a showing that plaintiff did rely on the market price. Otherwise, Rule 10b-5 would be converted into “a scheme of investor insurance”.

The dissenting justices could not embrace


157 Basic, Inc., 786 F.2d at 751.

158 Basic, Inc., 108 S. Ct. 978, 992 (1988). The Supreme Court addressed the problem of vexatious litigation in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), where it observed that interpreting the rule too broadly could greatly increase the number of eligible plaintiffs. Blue Chip Stamps, 421 U.S. at 740.

159 Justice Blackmun wrote the majority opinion in which Justices Brennan, Marshall and Stevens joined on the issues of materiality, Justices White and O’Connor joined but dissented on the fraud-on-the-market holding. Justices Rehnquist, Scalia and Kennedy took no part in the case.

a contemporary microeconomic theory because the Court had no staff economists, no experts schooled in the "efficient-capital-market hypothesis," and no ability to test the validity of empirical market studies.\(^{162}\) Justice White believed that if a change of the reliance requirement of Rule 10b-5 needs to be made, Congress with its superior resources and expertise, should do so.\(^{163}\)

**CONCLUSION**

In *United States v. Carpenter*, an equally divided Supreme Court upheld the decision of the Court of Appeals for the Second Circuit on the misappropriation theory. The Court held that a newspaper reporter violated Rule 10b-5 by using his knowledge of the contents and publication dates of forthcoming newspaper columns to trade profitably in securities. The government and lower courts utilized the misappropriation theory to circumvent the limitations of *Chiarella v. United States*.\(^{164}\) This four to four split of the Court is another indication that legislative clarification of the definition of "insider trading" is needed. The Boesky sentencing and future upcoming SEC actions should result in the SEC's ability to obtain a broader definition of "insider" and achieve this needed reform.

The unanimous opinion in Carpenter makes it clear that the unauthorized use of confidential business information can constitute fraud under the mail and wire fraud statutes.\(^{165}\) The SEC now has another means of criminally attacking insider trading which has Supreme Court approval.

The Supreme Court acceptance of the fraud-on-the-market theory advances the goals of federal securities law and permits investors to rely on the integrity of the market's pricing mechanism to establish securities prices. The acceptance of the fraud-on-the-market theory as a rebuttable presumption helps preserve investor confidence in the market's integrity and encourages investment in the United States. The *Basic* case follows earlier precedent that if significant negotiations are in progress, a statement that there are no pending negotiations or no pending corporate developments accounting for unusual stock prices would be false or misleading.\(^{166}\) The Court's rejection of a simple and clear test, like the agreement-in-principle test, as the basis of disclosure of merger negotiations in favor of a generally accepted Rule 10b-5 materiality standard furthers investors' information and knowledge. The rejection of a special test for materiality for merger negotiations is appropriate and the Court has made it clear that traditional standards of materiality will be followed. A significant future issue will ask when a company has a duty to comment on merger negotiations.


\(^{163}\) Id. at 995.

\(^{164}\) 445 U.S. 222 (1980).
