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Christine Marra
University of Richmond

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NOTES

THE MISAPPROPRIATION THEORY: A PRACTICAL MEANS OF IMPOSING RULE 10b-5 LIABILITY

I. Introduction

The degree of insider trading[1] has intensified in recent years.[2] This intensification is partially due to the current law's failure to provide a clear standard for imposing liability. Rule 10b-5,[3] formulated by the Securities and Exchange Commission (SEC) to implement section 10(b) of the Securities Exchange Act of 1934,[4] does not contain a clear definition of insider trading. The courts have struggled to define the scope of 10b-5; the

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1. Insider trading is generally defined as "trading in the securities market while in possession of material information that is not available to the general public." Note, United States v. Carpenter: *Second Circuit Overextends the Misappropriation Theory of Criminal Liability Under Rule 10b-5*, 12 Del. J. Corp. L. 605, 605 n.1 (1987). Insider trading may be conducted by two distinct groups of investors. These groups are referred to as "traditional" and "nontraditional" insiders. " 'Traditional insiders' are those directors, officers, controlling shareholders . . . who trade in their own company's securities." *Id.* at 612. "Nontraditional" insiders are those who trade while possessing an informational advantage. However, "nontraditional" insiders are not insiders of the issuer of the securities and they have not improperly received information from an insider. Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 Hofstra L. Rev. 101, 112 (1984).

2. From 1984 to 1988, 46 people were indicted for insider trading, while only 11 were convicted of insider trading between 1934 and 1984. 134 Cong. Rec. H7470 (daily ed. Sept. 13, 1988) (statement of Rep. Eckhart).

3. 17 C.F.R. § 240.10b-5 (1989). Rule 10b-5 reads:

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

Id.

4. 15 U.S.C. § 78j (1988).

leading case law demonstrates the difficulty courts have had determining what constitutes insider trading.

Recently, in *United States v. Newman*,[5] the Second Circuit formulated the misappropriation theory to overcome the obstacles to imposing liability that former case law had constructed.[6] This theory offers a pragmatic approach to the insider trading crisis by imposing liability on any person who trades on the basis of wrongfully acquired inside information.[7] The Supreme Court had the opportunity to endorse the misappropriation theory in *United States v. Carpenter*,[8] but being evenly divided on the issue, the Court did not comment on the theory's validity. Hence, while the Second Circuit may temporarily continue to use the theory, uncertainty exists as to whether the misappropriation theory will become the predominant theory used in insider trading prosecutions.[9]

This Note examines the effect of the misappropriation theory in cases involving trading by nontraditional insiders. It compares the equal access, fiduciary duty and misappropriation theories, emphasizing the misappropriation theory as a superior means of implementing the policy goals of Rule 10b-5. This Note also assesses the probability that the Supreme Court will adopt the theory.

II. History of the Misappropriation Theory

A. *The Rationale Behind Insider Trading Liability*

There are two main reasons for imposing liability on those who trade

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5. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983). In *Newman*, the Second Circuit held that an employee who traded on the basis of nonpublic information misappropriated from his employer violated 10b-5. By focusing on a duty other than that between a purchaser and seller of securities, the misappropriation theory endorsed in *Newman* expands 10b-5 liability to incorporate the actions of nontraditional insiders. Aldave, *supra* note 1, at 112.

6. In Chiarella v. United States, 445 U.S. 222 (1980), the Court restricted 10b-5 liability by requiring a fiduciary duty between the 10b-5 violator and the purchaser or seller of the securities involved. *Id.* at 232. The *Chiarella* rule impedes SEC and government prosecutors who attempt to eradicate insider trading, as much of the trading on nonpublic information is conducted by people who owe no direct duty to the person to whom they sell or from whom they buy securities. The *Chiarella* holding left prosecutors with no means of deterring the unfair trading activities of these investors.

7. Chief Justice Burger, whose dissent in *Chiarella* first articulated the fundamental principles of the misappropriation theory, emphasized the importance of wrongfulness. According to Burger, anytime "an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means," 10b-5 liability should be imposed. *Id.* at 240 (Burger, C.J., dissenting).

8. 484 U.S. 19 (1987).

9. There are two types of prosecutions for insider trading. Following an SEC investigation, there is an SEC prosecution which can lead to the imposition of civil penalties. The investigation results may also be used by federal prosecutors in a criminal suit.

securities on the basis of nonpublic information. First, commentators stress the need to restore the public's confidence in the securities market.[10] They fear that investors, aware of the recent surge of insider trading, will choose to withdraw from the securities market rather than risk being victims of this unlawful activity.[11] Mass withdrawal from the market could seriously impair the economy, although some commentators believe that insider trading is unlikely to stimulate severe economic demise.[12] These commentators find insider trading prohibitions justified by enforcing fairness in the securities market, a second widely noted rationale for imposing liability.[13]

B. *The Securities Laws*

The desire to instill fairness into securities transactions motivated Congress to enact the Securities Act of 1933[14] and the Securities Exchange Act of 1934.[15] Congress' goal was "to protect the investing public and honest business,"[16] implying a strong desire to ensure a fair price on securities rather than a price distorted by the mechanisms of insider trading.[17] This goal was codified in section 10(b) of the Securities Exchange Act of 1934[18] ("1934 Act") which authorized the SEC to formulate Rule 10b-5,[19] the main weapon against today's army of insider traders. Congress perceived Rule 10b-5 as a protective device, designed to shield the investor from the harmful effect of "manipulative or deceptive practices."[20] Originally, the congressional focus was on the manipulative or

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10. *E.g.*, Phelan, *Integrity is a Necessity on Wall St.*, 197 N.J.L.J. 29 (1987).
11. Cox & Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 354 (1988).
12. *Id.*
13. *Id.* at 357.
14. 15 U.S.C. §§ 77a to 77aa (1988).
15. 15 U.S.C. §§ 78a to 78ll (1988).
16. S. REP. No. 47, 73rd Cong., 1st Sess. (1983), *reprinted in* 2 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, at Item 17 (1973) [hereinafter 2 ELLENBERGER & MAHAR].
17. Transactions in securities are often executed by brokers with a specialist, a person who makes his living dealing in certain stocks. Wang, *Trading on Material Nonpublic Information on the Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1231 (1981). "[A]fter selling to an inside trader, a specialist . . . might increase price quotations; after buying from an inside trader, a specialist . . . might decrease his prices. On organized stock exchanges, changes in specialist price quotations would affect the prices of brokers 'trading in the crowd' around the specialist's booth." *Id.* at 1239. Thus, the price at which the broker buys or sells will be altered by the inside trading.
18. 15 U.S.C. § 78j (1988).
19. 17 C.F.R. § 240.10b-5 (1989).
20. S. REP. No. 792, 73rd Cong., 2d Sess. (1934), *reprinted in* 5 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES EXCHANGE ACT OF 1934, at Item 17 (1973)[hereinafter 5 ELLENBERGER & MAHAR]. The focus of section 10(b) was the elimination of the frequent transactions in which "directors and large stockholders participated in pools

deceptive practices of *traditional* insiders;[21] the problem of trading by nontraditional insiders was not expressly contemplated by Congress in 1934.[22]

Since 1934, however, the SEC and the courts have confronted the problem of nontraditional insiders.[23] In order to effectively implement the policy goals of the 1934 Act, the courts expanded the scope of 10b-5 to reach nontraditional insiders by formulating the equal access theory.

C. *Early Case Law: Evolution of the Equal Access Theory*

The case which began the era of 10b-5 expansion[24] was *In re Cady, Roberts & Co.*[25] There, the SEC imposed 10b-5 liability on an investment banker who traded Curtiss-Wright securities after receiving confidential information from a Curtiss-Wright director.[26] Under a traditional interpretation of 10b-5, the supplier of the information violated the rule because as a director, the supplier had a duty to the Curtiss-Wright shareholders.[27] The banker, however, did not have a duty to the shareholders.

The SEC found that the banker violated 10b-5, thereby extending the "disclose or abstain" rule[28] to nontraditional insiders. The SEC determined that a person has a duty to disclose or abstain if that person is in a relationship of trust which gives access to confidential information intended only for a corporate purpose.[29] The SEC demonstrated its belief

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trading in the stock of their own companies, with the benefit of . . . information not procurable by the investing public." *Id.*

21. *See supra* note 1.

22. Note, *Insider Trading: A New Equal Access Approach*, 15 J. CONTEMP. L. 51, 54 (1989).

23. *See supra* note 1.

24. *See* Note, *The SEC's Regulation of the Financial Press: The Legal Implications of the Misappropriation Theory*, 52 BROOKLYN L. REV. 43, 49 (1986) [hereinafter Note, *SEC's Regulation of the Financial Press*]; *see also* Note, United States v. Carpenter: *An Inadequate Solution to the Problem of Insider Trading*, 34 WAYNE L. REV. 1461, 1464 (1988)[hereinafter Note, *Inadequate Solution*].

25. 40 S.E.C. 907 (1961).

26. *Id.* at 912.

27. This duty was articulated in the following manner by the SEC:

> [I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances . . . the alternative is to forego the transaction.

Id. at 911.

28. *See id.*

29. The relationship of trust requirement implies that a person must owe a fiduciary duty to the corporation. This duty is acquired by a nontraditional insider when a relationship of trust exists between the nontraditional insider and a traditional insider, because the duty of the latter is imposed upon the former. Note, *supra* note 1, at 614.

that any trading situation in which a person relies upon facts unavailable to the other party is inherently unfair by instituting this comprehensive new standard, which encompassed both traditional and nontraditional insiders.[30]

This emphasis on fairness led the Second Circuit to establish an equal access theory of 10b-5 liability in *SEC v. Texas Gulf Sulphur Co.*[31] The *Texas Gulf Sulphur* court interpreted 10b-5 as an expression of the congressional intent "that all investors trading on impersonal exchanges have relatively equal access to material information."[32] This interpretation eliminated the relationship of trust requirement of *In re Cady*. Under the *Texas Gulf Sulphur* rule, even a person who inadvertently overheard material[33] confidential information would incur a duty to disclose or abstain. The equal access theory removed the obstacle to liability imposed by the relationship of trust requirement; however, the theory also enabled courts to award substantial damages to undeserving plaintiffs.

D. *The Equal Access Theory Applied in Private Actions*

Shapiro v. Merrill Lynch, Pierce, Fenner and Smith, Inc.[34] demonstrated the problem with draconian liability[35] that resulted from the use of the equal access theory in private 10b-5 actions. In *Shapiro*, the defendant tippers were found liable for damages to all plaintiffs who traded contemporaneously with their tippees.[36] The court emphasized the impossibility of identifying a specific defendant's sale with a specific plaintiff's purchase[37] and noted that its holding furthered the underlying purpose of 10b-5, which was "to prevent inequitable and unfair practices."[38] In fact, the result of the *Shapiro* decision was not as equitable as the court claimed, for it permitted any investor fortunate enough to have traded

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30. *In re Cady*, 40 S.E.C. at 912.

31. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

32. *Id.* at 848.

33. According to *Texas Gulf Sulphur*, "The basic test of materiality . . . is whether a reasonable man would attach importance (to the information) . . . in determining his choice of action in the transaction in question." *Id.* at 849 (quoting List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965)).

34. 495 F.2d 228 (2d Cir. 1974).

35. *See* Note, *Insider Trading and the Corporate Acquirer: Private Actions Under Rule 10b-5 Against Agents Who Trade on Misappropriated Information*, 56 GEO. WASH. L. REV. 600, 641-44 (1988).

36. *Shapiro*, 495 F.2d at 237. Merrill Lynch employees, working as underwriters for a corporation, disclosed confidential information concerning the corporation to their customers. The customer-tippees traded on the basis of the information and Merrill Lynch was held liable to *all* purchasers who traded during the period that these tippees traded. The tippees were also found to have violated 10b-5. *See* Note, *supra* note 1, at 616-17.

37. *Shapiro*, 495 F.2d at 236.

38. *Id.* at 240.

when the 10b-5 violators traded to gain a windfall.[39] Forcing one who profits from insider trading to disgorge the amount he gained from his illegal conduct conforms with our idea of justice. However, the ends of justice are not advanced when courts award investors merely for engaging in normal trading activity at the "right" time.

E. *The Fiduciary Duty Theory Replaces the Equal Access Rule*

The Supreme Court remedied this problem in *Blue Chip Stamps v. Manor Drug Stores*[40] by limiting the potential class of 10b-5 plaintiffs to people who had purchased or sold the security to which the violation related.[41] The Court sought to avert the danger of "vexatious litigation" resulting from the application of the *Texas Gulf Sulphur* rule to private actions, by making the buyer-seller fiduciary relationship an absolute prerequisite to recovery.[42] Cases following *Blue Chip Stamps* narrowed the scope of Rule 10b-5 even further[43] by establishing that violations of the law occur only where the insider's activity was fraudulent.[44] By making the fraud[45] element of 10b-5 indispensable, the Court dealt the first critical blow to the equal access theory.

The Supreme Court completely abrogated the equal access theory in *Chiarella v. United States*.[46] The Second Circuit upheld the conviction of Chiarella for 10b-5 violations resulting from trading on the basis of nonpublic information which he acquired through his job with a financial printing company.[47] In reversing Chiarella's conviction, the Court rejected the equal access rule.[48] The Court held that "a duty to disclose under Section 10(b) does not arise from the mere possession of nonpublic market information."[49] The majority noted that silence was not fraudulent in

39. *See* Note, *supra* note 35, at 643. This note further explains, "Even if those who actually traded with the defendant experience some sort of 'loss,' the number of investors who can recover against the defendant is much larger than the number of investors who actually traded with the defendant." *Id.*

40. 421 U.S. 723 (1975).

41. *Id.* at 747.

42. *Id.* at 740.

43. *See* Note, *supra* note 1, at 619-20.

44. *See* Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977). In *Santa Fe*, the Court examined the congressional intent behind section 10(b) of the Securities Exchange Act of 1934 and found "no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Id.* at 473; *see also* Ernst & Ernst v. Hochfelder, 425 U.S. 185, *reh'g denied*, 425 U.S. 986 (1976).

45. Fraud is referred to expressly in section (c) of the Rule, 17 C.F.R. § 240.10b-5(c) (1988).

46. 445 U.S. 222 (1980).

47. *Id.* at 224-25.

48. The Second Circuit had relied upon the equal access theory in convicting Chiarella. 588 F.2d 1358, 1369 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

49. *Chiarella*, 445 U.S. at 235.

the absence of an affirmative duty to disclose. As Chiarella was not someone in whom the sellers had placed their confidence, he had no duty to disclose and hence committed no fraud by trading on the information he obtained.[50]

The Court reaffirmed its rejection of the equal access theory in *Dirks v. SEC*.[51] Dirks, an investment analyst, received information from a former officer of Equity Funding of America that the corporation was replete with fraud. Dirks disclosed this nonpublic information to his clients who accordingly sold their Equity Funding securities.[52] The Court held that Dirks was not liable because the source of the information had not breached his duty to the Equity Funding shareholders,[53] and stated that "the tippee's duty to disclose or abstain is derivative from that of the insider's duty."[54]

F. *Critique of the Fiduciary Duty Theory*

While the fiduciary duty theory endorsed by *Blue Chip Stamps, Chiarella* and *Dirks* successfully limits liability in private 10b-5 cases, it also seriously impedes the SEC and government prosecutors in their efforts to extinguish insider trading. Much of the trading on nonpublic information is conducted by nontraditional insiders,[55] and the *Chiarella-Dirks* rule cannot impose liability upon nontraditional insiders trading on nonpublic information.[56] Hence, the fiduciary duty rule fails to discourage trading by people outside the corporation who gain access to material confidential corporate information.[57]

The failure of the fiduciary duty rule results from the Court's traditionally narrow idea of which relationships impose the fiduciary duty required under the *Chiarella-Dirks* analysis. The Second Circuit, through the application of the misappropriation theory, has based 10b-5 liability upon fiduciary duties other than those that run to shareholders and persons

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50. *Id.* at 232.

51. 463 U.S. 646, 657-58 (1983).

52. *Id.* at 648-49.

53. *Id.* at 666-67.

54. *Id.* at 659. A tippee is one to whom a corporate insider, the tipper, discloses confidential information.

55. Aldave, *supra* note 1, at 112.

56. For example, in most cases the fiduciary duty theory leaves an executive of one corporation free to trade on nonpublic information about another corporation because an insider of one company rarely has a fiduciary duty to the shareholders of another company. *Report of the Task Force on Regulation of Insider Trading, Part I*, 41 BUS. LAW. 223, 235 (1985).

57. Footnote 14 of the *Dirks* opinion creates a significant exception to the general fiduciary duty rule. It states that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders." *Dirks*, 463 U.S. at 655 n.14.

with whom the violator trades. By placing liability on anyone who trades on material confidential information that was wrongfully misappropriated,[58] the Second Circuit has significantly advanced the goals of section 10(b).

III. THE MISAPPROPRIATION THEORY

A. *Development of the Theory*

1. Chief Justice Burger's Dissent in *Chiarella v. United States*[59]

The misappropriation theory was originally formulated by Chief Justice Burger in his *Chiarella* dissent. While generally supporting the fiduciary duty rule,[60] Chief Justice Burger asserted that the rule should not preclude liability any time "an informational advantage is obtained, not by superior experience, foresight or industry, but by some unlawful means."[61] Thus, any person who breaches a duty[62] by misappropriating nonpublic information unlawfully acquires an informational advantage and is liable under this theory.[63]

The Court did not consider the misappropriation theory in *Chiarella* because the theory had not been submitted to the jury.[64] Review of the Second Circuit cases in which the theory has been applied, however, illustrates that it is a practical compromise between the *Chiarella-Dirks*[65] analysis and the equal access rule.

2. Application of the Theory in the Second Circuit

United States v. Newman[66] established the misappropriation theory as an invaluable asset to the SEC in its struggle to eradicate insider trading. Newman obtained confidential information from insiders of investment banking firms concerning the proposed acquisitions of their corporate cli-

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58. *See* Chiarella v. United States, 445 U.S. 222, 240 (Burger, C.J., dissenting).

59. *Id.*

60. *See id.* at 239-40.

61. *Id.* at 240.

62. The misappropriation theory requires a specific duty to individuals or a corporation; the assertion that the misappropriator owes a general duty of disclosure to the entire marketplace is an insufficient basis for liability. Aldave, *supra* note 1, at 115 n.76. The specificity requirement was incorporated into the theory by the Second Circuit, when it rejected Chief Justice Burger's assertion that "a person who has misappropriated nonpublic information has an absolute duty to disclose." *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

63. Applying the misappropriation theory, Chiarella certainly violated 10b-5 by trading on confidential information he received not because of his outstanding foresight, but because he "stole" that information from his employer. *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

64. *Id.* at 235-36.

65. Dirks v. SEC, 463 U.S. 646 (1983).

66. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

ents. Newman purchased stock in the target companies on the basis of this information.[67] The Second Circuit held that his action violated 10b-5 because Newman and his tippers wronged the investment banking firms by sullying their reputation and wronged the firms' clients as well.[68]

The court in *Newman* was able to overcome the absence of a duty running from the violators to the sellers by premising liability on the duty owed by the investment bankers to their employers and employers' clients.[69] The misappropriation theory, therefore, continues to stress the fiduciary duty requirement,[70] but does not construe this duty so narrowly as to hinder attempts to abolish insider trading activity.[71] The misappropriation theory endorsed by *Newman* should be utilized by courts outside the Second Circuit, because of its vitality in controlling trading by nontraditional insiders.

SEC v. Musella[72] demonstrates the theory's capacity to impose 10b-5 liability on nontraditional insiders who would be free to trade with their informational advantage under a strict interpretation of a fiduciary duty. In *Musella*, bond traders were given nonpublic information by a law firm's office manager concerning the firm's corporate clients.[73] The court found that if it used the *Chiarella-Dirks* rationale, the defendants were not liable since their tipper owed no duty to the shareholders and corporations whose securities were traded.[74] Turning to a *Newman* analysis, the court determined that the defendants' tipper (the office manager) owed a duty to the law firm and to the firm's clients to refrain from trading on the basis of misappropriated corporate information. As tippees, the defendants acquired the duty to abstain[75] and hence violated 10b-5 through their trading activities.[76] *Musella* illustrates that the misappropriation theory is far more capable of furthering the goals of fairness and

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67. 664 F.2d at 14-15.

68. *Id.* at 15. By artificially inflating the price of the target corporations' stock, Newman and his cohorts made acquisition by the corporate clients more costly. *Id.* at 17.

69. Under the *Dirks* rule Newman, as their tippee, incurred the investment bankers' duty to the corporation.

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

71. *See* SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985). *Materia* illustrates the misappropriation theory's duty concept. Like Chiarella, Materia worked for a financial printer, misappropriated confidential information from his employer, and traded on the basis of that information. *Id.* at 199. The justice of his conviction underscores the need for the Court to adopt the misappropriation theory and properly penalize the Chiarellas of the securities market.

72. 578 F. Supp. 425 (S.D.N.Y. 1984).

73. *Id.* at 431-33.

74. *Id.* at 436-37.

75. *See* Note, *SEC's Regulation of the Financial Press*, *supra* note 24, at 56 (stating that under the misappropriation theory there is no duty to disclose; one who obtains confidential corporate information *must* abstain from trading on it).

76. *Musella*, 578 F. Supp. at 439.

equity than the *Chiarella* style fiduciary duty rule.[77]

3. *United States v. Carpenter*[78]

In *Newman* and *Musella* the court recognized a two-tiered fiduciary duty running to both the employer and the corporate client.[79] While some think a two-tiered duty should be a prerequisite for application of the theory,[80] requiring the violator to breach a duty on two levels would unduly restrict the utility of the misappropriation theory. Premising liability on the existence of an employer-client duty allows employees to trade on misappropriated information as long as the trading does not affect the limited number of companies with which the employer deals.[81] Thus, a two-tiered duty requirement imposes an artificial barrier to liability, similar to the *Chiarella* requirement that a defendant owe a duty to the purchaser or seller.[82]

The Second Circuit refuted the notion that the misappropriation theory required a two-tiered duty in *United States v. Carpenter*.[83] *Carpenter* involved Winans, an employee of the *Wall Street Journal* who co-authored a financial column[84] which was widely read and significantly influenced its readers' transactions of securities.[85] Winans used his advance notice of the timing and content of the column to trade profitably in the securities the column discussed,[86] in direct violation of *Journal* policy.[87]

The Second Circuit rejected the argument that "the misappropriation theory may be applied only where the information is misappropriated by corporate insiders or so-called quasi-insiders,"[88] and held that Winans vi-

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77. *But cf.* Note, *Inadequate Solution*, *supra* note 24, at 1472 (describing *Musella* as confusing).

78. 791 F.2d 1024 (1986), *aff'd*, 484 U.S. 19 (1987).

79. *See* Note, *Inadequate Solution*, *supra* note 24, at 1473.

80. *See id.*

81. Consider a financial analyst whose assignment is to develop predictions on the basis of compilations of public information obtained from his employer. If the analyst traded on the basis of his predictions, he would have violated *only* a duty to his employer, and hence would not be liable under a theory requiring a two-tiered duty. The two-tiered duty requirement, therefore, would allow this analyst to profit from the use of nonpublic information he stole from his employer.

82. *See supra* note 50 and accompanying text.

83. 791 F.2d 1024 (1986), *aff'd*, 484 U.S. 19 (1987).

84. *Id.* at 1026. The column analyzed trading activity and advised investors on whether to invest in certain stock. *See* Note, *supra* note 1, at 630.

85. Note, *SEC's Regulation of the Financial Press*, *supra* note 24, at 80.

86. 791 F.2d at 1026-27.

87. The *Journal* distributed a pamphlet to all of its employees detailing its conflict of interest policy, which stressed that all news learned by an employee in the course of his employment was company property and that any nonpublic information acquired on the job had to be treated as confidential. *Id.* at 1026.

88. *Id.* at 1028. Quasi-insiders are those who acquire a duty to the corporation through

olated 10b-5. The court found that when Winans breached his duty to his employer, he committed a fraud sufficient to warrant 10b-5 liability.[89]

When *United States v. Carpenter* reached the Supreme Court, the Justices were split on the issue of whether Winans had violated 10b-5; hence, they affirmed the Second Circuit's decision without commenting on the merits of the misappropriation theory.[90] While the Court's silence enables the SEC and government prosecutors to continue to use the misappropriation theory, its use could be rapidly terminated if the Court adopts the views espoused by the many critics of the theory.

B. *Criticism of the Theory*

The *Carpenter* decision provoked a profusion of criticism. This criticism focuses on the misappropriation theory's flexibility, which is perceived as excessive;[91] the theory's interpretation of "fraud", which is viewed as too broad;[92] and the theory's failure to compensate the people who are most severely damaged by the illegal trading.[93]

1. The Theory's "Excessive" Flexibility

Carpenter disturbs critics because they believe it warps the definition of confidential inside information. They claim that the publication schedule was not inside information because it did not issue directly from a corporation whose stocks were traded.[94] However, whether information emanates from a corporation is not the crucial factor in determining if this information is protected by 10b-5. Rather, the materiality[95] and confidentiality of the information determines if it is covered by Rule 10b-5.

The critics also assert that the information contained in the articles was not confidential, but rather a compilation of the public information gathered by Winans.[96] While the information compiled in Winans' articles was available to the public, the analysis in the articles and the articles' publication dates were not. Advance knowledge of this information, not of the unembellished facts gained from the individual corporations, enabled Winans to profit in his securities transactions.[97]

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their tippers or *Dirks'* footnote 14. *See supra* note 57.

89. *Id.* at 1032.

90. 484 U.S. 19, 24 (1987).

91. Note, *supra* note 1, at 637-38; *see also* Note, *SEC's Regulation of the Financial Press*, *supra* note 24, at 79.

92. Note, *Inadequate Solution*, *supra* note 24, at 1481.

93. Cox & Fogarty, *supra* note 11, at 366.

94. Note, *supra* note 1, at 637-38.

95. *See supra* note 33.

96. Note, *SEC's Regulation of the Financial Press*, *supra* note 24, at 79.

97. United States v. Carpenter, 791 F.2d 1024, 1031 (1986), *aff'd*, 484 U.S. 19 (1987). As

These critics assert that by flexibly construing the characteristics of confidential information, the misappropriation theory allows courts to impose criminal liability on people who do nothing more delinquent than violate the internal rules of an organization.[98] These critics attach a rigidness to 10b-5 that was never intended by the framers of the 1934 Act.[99] The framers of the 1934 Act emphasized the need to allow considerable latitude in the administration of the Act's provisions in order to avoid an "unworkable 'straitjacket' regulation."[100] To interpret confidentiality and inside information as narrowly as these critics suggest would counteract the framers' intent by transforming section 10(b) of the 1934 Act into an unworkable regulation.

2. The Theory's Broad Interpretation of Fraud

A second criticism is that the misappropriation theory overextends the concept of fraud[101] by finding fraud where no real damages exist.[102] In *Carpenter*, the Second Circuit determined that the damage resulting from Winan's fraudulent trading was the harm done to the *Journal*'s reputation.[103] However, as there was no decline in the *Journal*'s circulation, it appears that no actual harm was done to the paper's integrity.[104] Because there was no perceived damage to the alleged victim of Winans' activities, critics claim that Winans did not commit fraud and that the court abandoned the fraud requirement, making "the reach of the securities laws limitless."[105]

The critics' perception of the effects of insider trading is unduly narrow. They focus only on a single potential victim rather than on the full effects of the defendant's actions. While the harm to the *Journal* was potential rather than actual, significant real damage was done to a large group of unidentifiable investors.[106] His fraud did cause actual damage,

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the effect of the articles on the public's trading activities was the crucial factor in Winans' scheme, the timing of the articles' publication was material. Since the future publication dates were not known to the public, they were clearly confidential. Additionally, it is difficult to accept the critics' assertion that the information was not confidential in light of the *Journal*'s stated policy. *See supra* note 87.

98. Note, *Inadequate Solution*, *supra* note 24, at 1479.

99. The Senate Report on the Act emphasized that "so delicate a mechanism as the modern stock exchange cannot be regulated efficiently under a rigid statutory program." 5 ELLENBERGER & MAHAR, *supra* note 20, at 5.

100. *Id.*

101. *See* Note, *Inadequate Solution*, *supra* note 24, at 1481.

102. A basic element of fraud is damage. BLACK'S LAW DICTIONARY 594 (5th ed. 1979).

103. United States v. Carpenter, 791 F.2d 1024, 1032 (1986), *aff'd*, 484 U.S. 19 (1987).

104. Note, *SEC's Regulation of the Financial Press*, *supra* note 24, at 81.

105. Note, *Inadequate Solution*, *supra* note 24, at 1481.

106. Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 OHIO ST. L.J. 373, 379 (1988) (explaining that "[t]he defendants inflicted concrete economic injuries on those anonymous investors who were induced by the defendants' trading to buy or sell

since investors relied on Winans' column in their decision making and substantial damage was done to these investors because of this reliance.[107]

The absence of a link between the party to whom the breach of duty relates and the persons who are most severely damaged has caused critics to deem the misappropriation theory "merely a pretext for enforcing equal opportunity in information."[108] Yet there exists an important distinction between the misappropriation and equal access theories. Where the equal access standard imposed liability upon anyone trading on the basis of inside information regardless of how that information was obtained,[109] the misappropriation theory requires that the inside information be acquired wrongfully.[110] The misappropriation theory penalizes those who secure informational advantages through deceitful means. Unlike the equal access theory, however, it does not impose liability on investors who acquire material, nonpublic information through skill[111] or good fortune.[112]

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securities on unfavorable terms, or were preempted by the defendants' trading from buying or selling securities on favorable terms.").

107. "Elements of a cause of action for fraud include false representation of a present or past fact made by defendant, action in reliance thereupon by plaintiff, and damage resulting to plaintiff from such misrepresentation." BLACK'S LAW DICTIONARY 594 (5th ed. 1979). Although this standard definition of fraud refers to plaintiff and defendant, it may also be applied in the context of criminal and SEC actions involving insider trading. *See* Aldave, *supra* note 106, at 379.

108. Cox & Fogarty, *supra* note 11, at 366. These critics point to the fact that the fraud must be committed "in connection with the purchase or sale of any security" (Rule 10b-5(c)). They claim that because the fraud in *Carpenter* was not committed on a purchaser or seller of securities, it does not satisfy the "in connection with" element. Again, their interpretation of 10b-5 is unduly limiting. As the purpose of Winans' misappropriation was to financially benefit from securities transactions, his fraud quite obviously was "in connection with the purchase or sale" of securities. *See* United States v. Carpenter, 791 F.2d 1024, 1032 (1986), *aff'd*, 484 U.S. 19 (1987).

109. *See* SEC v. Texas Gulf Sulphur, 401 F.2d 833, 851 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (stating "The core of Rule 10b-5 is the implementation of the Congressional purpose . . . that all members of the investing public should be subject to identical market risks . . . . ").

110. *See Carpenter*, 791 F.2d at 1031; *see also* Chiarella v. United States, 445 U.S. 222, 240-42 (Burger, C.J., dissenting) (discussing his opinion that anyone who misappropriates nonpublic information has an absolute duty to disclose or refrain from trading).

111. *Carpenter*, 791 F.2d at 1031.

112. The case of SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984) illustrates this distinction between the equal access and misappropriation theories. Switzer overheard a corporate insider discussing nonpublic information and later used this information to determine his securities trading choices. The court did not impose 10b-5 liability in this case as neither the corporate insider nor Switzer breached a fiduciary duty. *Id.* at 765. *Switzer*'s result emphasizes the fairness of distributing liability on the basis of wrongfulness. It certainly would not have been fair to hold a man liable for simply taking advantage of his good fortune, yet this would have been the result had the court applied the equal access theory. Thus, *Switzer* refutes the notion that the misappropriation theory is merely the old equal access theory under a new name. *But cf.* United States v. Reed. 601 F. Supp. 685 (S.D.N.Y.), *rev'd on*

3. The Theory's Failure to Compensate Investors

While the misappropriation theory justly determines liability, some critics feel it unjustly denies a cause of action for the real victims of the securities fraud.[113] Such critics fail to consider the pivotal role a fiduciary duty plays in establishing 10b-5 liability. A plaintiff cannot bring an action against the employee of a company that owes him no fiduciary duty, because he cannot establish the existence of a duty between himself and that employee.[114] With no such duty, the employee has not directly defrauded the plaintiff; the plaintiff is merely part of the investing public that has been adversely affected by the fraud perpetrated on the violator's employer. To grant these plaintiffs standing to sue for damages would go against the rule in *Blue Chip Stamps v. Manor Drug Stores*[115] and provoke the type of "vexatious litigation" that the rule was designed to abort.[116]

The extreme difficulty of accurately determining damages further justifies the courts' unwillingness to apply the misappropriation theory to private actions.[117] Calculating the pecuniary loss to a plaintiff trading contemporaneously with the defendant is a speculative venture, because factors other than the misappropriator's trading activity can often affect changes in securities pricing.[118] Awarding damages thus often results in an unjustifiable redistribution of wealth. The courts' unwillingness to use the misappropriation theory to grant damage awards to plaintiffs who lack a fiduciary duty towards defendants illustrates that the theory can successfully fulfill the policy goals of Rule 10b-5 without imposing the draconian liability that developed out of the equal access rule.[119]

IV. The Future of the Misappropriation Theory

The misappropriation theory provides a means of restoring integrity and fairness to the securities market without unduly punishing investors who act without wrongful intent and without unjustifiably rewarding investors to whom the violators owed no duty. It is a practical tool for de-

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other grounds, 773 F.2d 477 (2d Cir. 1985).

113. *See* Cox & Fogarty, *supra* note 11, at 366.

114. *See* Moss v. Morgan Stanley, Inc., 719 F.2d 5, 13 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984). This case established that the misappropriation theory would not apply in civil actions for damages. Following *United States v. Newman*, *Moss* determined that "an employer's duty to 'abstain or disclose' with respect to his employer should (not) be stretched to encompass an employee's 'duty of disclosure' to the general public." *Id.*

115. 421 U.S. 723 (1975).

116. *See supra* note 42 and accompanying text; *see also Moss*, 719 F.2d at 16.

117. *But cf.* FMC Corp. v. Boesky, 852 F.2d 981 (7th Cir. 1988) (granting standing to plaintiff corporation to which defendant 10b-5 violators owed no fiduciary duty).

118. Note, *supra* note 35, at 645-46.

119. *See supra* notes 35-39 and accompanying text.

termining 10b-5 liability that should be used throughout the federal court system. Whether the theory will be universalized depends ultimately on the Supreme Court's acceptance or rejection of the theory.[120]

A. United States v. Carpenter[121]

Because the Court in *Carpenter* was "evenly divided with respect to the convictions under the securities laws,"[122] their decision did not determine whether the misappropriation theory is valid. There is no way to determine how each of the individual Justices voted on the 10b-5 issue in *Carpenter*, with the exception of Justice White who seemingly endorsed the theory in his discussion of the mail and wire fraud counts. Throughout his discussion, Justice White stressed the significance of the employee-employer fiduciary duty.[123] His emphasis on this duty suggests that he would find its breach by a misappropriator of confidential securities information critical enough to justify imposition of 10b-5 liability.

B. *Predictions based upon* Chiarella v. United States[124]

While it is impossible to determine how the other members of the Court voted on the misappropriation issue in *Carpenter*, the views of some of these Justices can be discerned from *Chiarella*. Of the five Justices who issued separate decisions in *Chiarella*, four remain on the Court. Analysis of their decisions gives some indication of how they would decide a typical insider trading case in which liability is based on the misappropriation theory.[125]

Justice Stevens, in his concurring opinion in *Chiarella*, detailed arguments for and against the misappropriation theory but did not comment on whether he approved of the theory. His articulation of the theory differs from that of the Second Circuit, for it focuses on a duty owed by the

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120. There is also the possibility that each of the federal circuits will adopt the misappropriation theory independently. Thus far, only three circuits in addition to the Second Circuit have applied the theory: the Ninth Circuit in SEC v. Clark, 699 F.Supp. 839 (W.D. Wash. 1988); the Seventh Circuit in FMC Corp. v. Boesky, 852 F.2d 981 (7th Cir. 1988); and the Third Circuit in Rothberg v. Rosenbloom, 771 F.2d 818 (3rd. Cir. 1985), *cert. denied*, 481 U.S. 1017 (1987).

121. 791 F.2d 1024 (1986), *aff'd*, 484 U.S. 19 (1987); *see supra* notes 78-90 and accompanying text.

122. 484 U.S. 19, 24 (1987).

123. *Id.* at 27-28.

124. 445 U.S. 222 (1980); *see supra* notes 46-50 and accompanying text.

125. *Carpenter* is atypical because it does not deal with misappropriation of confidential information that has been entrusted to employers by clients preparing to undergo corporate acquisitions, as *United States v. Newman* and *SEC v. Musella* did. Thus, it is possible that some of the Justices who rejected the misappropriation theory in *Carpenter* did so because they believed it was inapplicable to the facts, not because they found the theory itself invalid. *See Aldave, supra* note 106, at 375.

employee to the acquiring company.[126] His focus on the duty owed by the employee to the acquiring company indicates that Justice Stevens believes the misappropriation theory requires a two-tiered duty.[127] The absence of the second tier[128] could have caused Justice Stevens to vote against imposing liability in *Carpenter*; however, he may well support the use of the misappropriation theory in cases where a duty can be traced to both the employer and the client.

Justice Brennan in *Chiarella* clearly endorsed the misappropriation theory in his concurrence, stating "a person violates §10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."[129] As Winans clearly violated 10b-5 according to this standard, Brennan probably would have found Winans guilty of a 10b-5 violation.

In his dissent in *Chiarella*, Justice Blackmun, with whom Justice Marshall joined, dispensed with the fiduciary duty requirement and stated that any manipulative trading "lies close to the heart of what the securities laws are intended to prohibit."[130] While they held that the misappropriation theory is not *necessary* to find liability where the trader's actions are wrongful,[131] Blackmun and Marshall implied that they would not reject the misappropriation theory. Justices Blackmun and Marshall probably would have supported application of the theory in *Carpenter*.

The analysis of the concurrences and dissents in *Chiarella* suggests that if a standard nontraditional insider trading case were to come before the Court tomorrow, use of the misappropriation theory would be upheld. Justices White, Brennan, Blackmun and Marshall, who would have most likely supported use of the theory in *Carpenter*, would be joined by Justice Stevens as a standard nontraditional insider case involves a two-tiered duty. However, if a case involving only a single-tiered duty were to come before the Court, the fate of the misappropriation theory would be determined by Justice Kennedy.[132]

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126. *Chiarella*, 445 U.S. at 237-38 (Stevens, J., concurring).

127. *See supra* note 79 and accompanying text.

128. In *Carpenter*, the *Journal* had no corporate client to whom Winans could have owed a duty.

129. *Chiarella*, 445 U.S. at 238-39 (Brennan, J., concurring). Although Justice Brennan accepted the Chief Justice's theory, he concurred with the majority because he found the jury had not been instructed with respect to the misappropriation theory. *Id.* at 239.

130. *Id.* at 246 (Blackmun, J. and Marshall, J., dissenting).

131. *Id.* at 245.

132. Justice Kennedy did not come onto the Court in time to hear *Carpenter*. Justice Kennedy would hold the crucial vote in a single-tiered duty case because, presumptively, Justice Stevens would not uphold a conviction arrived at through the misappropriation theory if no two-tiered duty existed.

C. *The Influence of Justice Kennedy*

Justice Kennedy's stance on the misappropriation theory is not easily anticipated. According to one of Justice Kennedy's critics, "He wants less government and he wants to let the marketplace rule."[133] Freedom of the marketplace implies allowing those who obtain information from corporate insiders to freely trade without incurring liability.[134] On the other hand, the misappropriation theory may enhance market freedom by insuring that the market is not controlled by a small group of corporate insiders,[135] and hence receive Justice Kennedy's approval. However, most economists agree that insider trading does not account for the general public's failure to invest in securities, and hence stricter prohibitions on insider trading would not affect the public's market participation.[136] Therefore, it is likely that Kennedy will view the misappropriation theory as a restraint upon the free-market system and refuse to endorse its use.

Further evidence that Justice Kennedy will not support use of the theory in a single-tier duty case is his tendency to focus on the "plain meaning" of statutes which he interprets.[137] Emphasis on the "plain meaning" of Rule 10b-5 may persuade Kennedy to invalidate convictions based upon a breach of a single duty. As noted previously, strict constructionists criticize the misappropriation theory's broad interpretation of fraud which enables liability to be imposed in single-tier duty cases.[138] Therefore, if Kennedy chooses to focus only on the "plain meaning" of the lan-

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133. Williams, *The Opinions of Anthony Kennedy: No Time for Ideology*, A.B.A. J., Mar. 1, 1988, at 60 (quoting Junior Bridge, N.O.W. spokeswoman). Justice Kennedy's decision in American Fed'n of State, County, and Mun. Employees (AFSCME) v. State of Washington, 770 F.2d 1401 (9th Cir. 1985) prompted this criticism. In *AFSCME*, Justice Kennedy, writing for the court, determined that the federal courts could not prohibit the state from paying a higher wage in male-dominated jobs than for comparable female-dominated jobs. According to Kennedy the courts could not "interfere in the market-based system for the compensation of . . . employees." *Id.* at 1408.

134. *See* Manne, *Insider Trading and Property Rights in New Information*, in ECONOMIC LIBERTIES AND THE JUDICIARY 317 (J.A. Dorn & H.G. Manne ed. 1987). Professor Manne feels strict government proscription of insider trading restricts market freedom by limiting a corporation's ability to create its own policies regarding insider trading. *Id.* at 324. Additionally, Professor Manne views regulation of insider trading as an attempt by the government to reallocate wealth and hence adverse to our democratic system. *Id.* at 326; *see also* Wolfson, *Civil Liberties and Regulation of Insider Trading*, in ECONOMIC LIBERTIES AND THE JUDICIARY 329 (J.A. Dorn & H. G. Manne ed. 1987) (discussing *Carpenter* as illustrating how insider trading regulation violates the first amendment).

135. *See* Cox & Fogarty, *supra* note 11, at 354-57. The misappropriation theory's ability to impose liability on a larger group of traders should increase investors' confidence in the fairness of the securities market, and thus encourage more investment by the general public. *Id.* at 354.

136. *E.g., id.*

137. Schwartz, *Kennedy: The Newest Justice Stakes Out His Position: The "Gray Market" Case, "Plain Meaning" and Other Portents*, L.A. Daily J., Sept. 30, 1988, at S2, col.1.

138. *See supra* notes 101-05 and accompanying text.

guage in 10b-5, he will probably not endorse use of the theory to find liability in a single-tier duty case.

Review of Kennedy's Ninth Circuit decisions shows, however, that while Kennedy does look toward statutory language, he considers that language in conjunction with the legislative history of the statute.[139] For example in *United States v. Crocker National Corporation*[140] Kennedy, disagreeing with the majority's broad interpretation of the term "banks" in Section 8 of the Clayton Act, emphasized the congressional intent behind the statutory language.[141] As the congressional intent behind the Securities Exchange Act of 1934 was to eliminate "methods . . . employed by large operators and those possessing inside information regarding corporate affairs . . . [which have] been contributing causes to losses to investors,"[142] Kennedy may see application of the misappropriation theory in single-tier cases as a means of advancing congressional goals and may support such an application.

The ultimate determination of Justice Kennedy's probable stance on the misappropriation theory requires a balancing of Kennedy's free market bias and his concern with legislative intent. Kennedy's focus on legislative intent is most evident in cases where this focus leads to enhanced market freedom.[143] Therefore, it is unlikely that he will allow vague congressional references to "methods" employed by "those with inside information" to persuade him to favor a decision which will hinder greater individual freedom in the market. Kennedy will probably not endorse use of the misappropriation theory in a single-tier duty case such as *Carpenter* unless Congress expressly authorizes such use.

D. *Congressional Action Regarding Insider Trading and the Misappropriation Theory*

Two bills regarding insider trading have come before Congress in the past two years.[144] Only the later bill, The Insider Trading and Securities

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139. *E.g.*, American Fed'n of State, County, and Mun. Employees v. State of Washington, 770 F.2d 1401 (9th Cir. 1985).

140. 656 F.2d 428 (9th Cir. 1981).

141. *Id.* at 456 (Kennedy, J., dissenting).

142. 5 ELLENBERGER & MAHAR, *supra* note 20, at 3.

143. *See Crocker*, 656 F.2d at 456.

144. Prior to the proposition of these two bills, Congress enacted two new statutes designed to curb insider trading activity. First, Congress amended section 14(e) of the Securities Exchange Act of 1934 with passage of the Williams Act, 15 U.S.C. § 78n(e) (1988). This amendment proscribed fraudulent practices in the tender offer context, *id.*, and authorized the SEC to promulgate Rule 14(e)-3. 17 C.F.R. § 240.14e-3 (1989). Rule 14(e)-3 imposes a duty to abstain from trading upon anyone in possession of material, nonpublic information regarding a tender offer, regardless of whether that person owes a fiduciary duty. *See* Phillips & Zutz, *The Insider Trading Doctrine: A Need For Legislative Repair*, 13 HOFSTRA L. REV. 65, 95 (1984).

Fraud Enforcement Act of 1988[145] (the "1988 Act") was accepted. While the 1988 Act increases the penalties for insider trading[146] and legitimizes private causes of action for contemporaneous traders,[147] it fails to clearly define the crime. This failure does not, however, result from an inability to formulate a definition of insider trading, for such a definition was included in the earlier bill not yet approved by Congress known as the Insider Trading Proscription Act of 1987 ("ITPA").[148]

The ITPA, introduced to the 100th Congress as Senate Bill 1380, contains a broad definition of insider trading which incorporates the misappropriation theory.[149] Like the misappropriation theory, the ITPA stresses the wrongfulness of the trader's means of acquiring inside information.[150] However, the ITPA's definition of wrongful acquisition is much broader than that of the misappropriation theory. Under the proposed ITPA, liability is imposed upon any person trading on the basis of nonpublic information who "knows or recklessly disregards that such information has been obtained wrongfully" and whose trading "would constitute, directly or indirectly . . . any . . . breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship."[151] By eliminating Rule 10b-5's fraud requirement[152] and enlarging the class of duties which, if breached, would lead to liability, the ITPA provides a clear means of consistently convicting insider traders in single-tier duty cases.

While the ITPA advances the policy goals of 10b-5[153] as successfully as the misappropriation theory does, it also contains provisions allowing for private causes of action which would lead to the draconian damages the

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Congress also passed the Insider Trading Sanction Act of 1984. 15 U.S.C. § 78u(d)(2)(A) (Supp. III 1985). The act provided civil penalties to be imposed upon anyone violating the 1934 Act and anyone aiding or abetting such a violator. The main significance of the 1984 act was that it increased the maximum fine for those guilty of insider trading from $10,000 to $100,000.

145. Pub. L. No. 100-704, 102 Stat. 4677 (1988).

146. The 1988 Act increases the maximum fine accompanying a conviction for insider trading from $100,000 to $1,000,000 and increases the maximum jail sentence from five to ten years. *Id.* at 4678.

147. *Id.* at 4680. The 1988 Act declares that limited damages may be granted to traders who, contemporaneously with the purchase or sale of securities to which the violation relates, purchased (if the violation is based upon a sale of securities) or sold (if the violation is based upon a purchase of securities) securities of the same class. *Id.*

148. S. 1380, 100th Cong., 1st Sess. (1987), *reprinted in* [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,202 (Nov. 16, 1987).

149. *See id.* at 88,916 (proposed 1934 Act § 16(A)(b)(1)).

150. *Aldave, supra* note 106, at 385.

151. S. 1380, 100th Cong., 1st Sess. (1987), *reprinted in* [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,202, at 88,916 (Nov. 16, 1987) (proposed 1934 Act § 16(A)(b)(1)); *see Aldave, supra* note 106, at 386.

152. *See Aldave, supra* note 106, at 385-87.

153. *See supra* notes 16-20 and accompanying text.

courts have avoided through their use of the misappropriation theory. Proposed section 16(A)(g)(1)[154] asserts that damages may be recovered not only by those who traded contemporaneously with the violators, but also by *any* person "injured by violation of this section in connection with such person's purchase or sale of securities."[155] It appears that because of the near impossibility of identifying the investors who are actually, rather than potentially, harmed by the violator's trading,[156] the framers of the ITPA chose to grant the entire class of potential victims a windfall.[157] The proposed act therefore, unlike the misappropriation theory, fails to strike a balance between furtherance of Rule 10b-5's goals and avoidance of unjust compensation of "lucky" investors.[158] The draconian nature of the ITPA was, in fact, a primary cause of its rejection by Congress.[159]

Both the Insider Trading and Securities Fraud Enforcement Act of 1988 and the ITPA demonstrate continued congressional concern with curing the insider trading epidemic. Furthermore, the ITPA's incorporation of the misappropriation theory and its capacity to impose liability in single-tier duty cases illustrate that Congress has considered codification of the theory as it was applied in *Carpenter*. Significantly, it does not appear that Congress rejected the ITPA because it disapproved of the misappropriation theory. Rather, Congress apparently rejected the proposed act because it viewed its damages provision as draconian. Since the misappropriation theory does not lead to oppressive damages, it appears likely that Congress would accept a bill that incorporates the theory as it was used by the Second Circuit in *Carpenter*.[160]

V. CONCLUSION

To insure that nontraditional insiders such as Winans will not be able to use their positions to exploit the investing public, the Court needs to endorse the misappropriation theory as it was used by the Second Circuit in *Carpenter*. Such an endorsement would conform with general congressional notions of insider trading, as the Insider Trading Proscription Act illustrated congressional willingness to accept the misappropriation theory's use in single-tier duty cases. Only if the Court accepts a theory imposing liability even when just a single-tiered duty exists will the govern-

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154. S. 1380, 100th Cong., 1st Sess. § 16(A)(g)(1) (1987), *reprinted in* [Current] Fed. Sec. L. Rep. (CCH) ¶ 84,202, at 88,917 (Nov. 16, 1987).

155. *Id.* The proposed ITPA differs from the 1988 Act accepted by Congress, in that the 1988 Act limits the class of plaintiffs to those who traded contemporaneously with the Act's violators. *See supra* note 147 and accompanying text.

156. *See* Note, *supra* note 35, at 643 & n.228.

157. *See* Note, *supra* note 35 and accompanying text.

158. *See id.*

159. Bahls, *This Little Piggy Went To Market*, Student Lawyer, Oct. 1989, at 18.

160. *But cf. id.* at 22 (noting that Congress is not likely to pass the ITPA in the near future).

ment be able to successfully implement the goals of Section 10(b) of the Securities Exchange Act of 1934.

Christine Marra