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The Misappropriation Theory: Too Much of a Good Thing?

In recent cases, criminal liability for violation of rule 10b-5 of the 1934 Securities and Exchange Act has been imposed upon persons who have traded in the securities markets using illegally obtained, nonpublic information. Until recently, criminal liability for violations of rule 10b-5 was based upon the violation of the fiduciary duty of a corporate insider using private corporate information to manipulate the stock market. The Second Circuit Court of Appeals, however, has fashioned a theory based upon the misappropriation of confidential information to expand liability for trading with material nonpublic information. The misappropriation theory makes nondisclosure of


2. 17 C.F.R. §240.10b-5. Rule 10b-5 states:
   It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or mails or of any facility of any national exchange,
   (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 light of the circumstances under which they were made, not misleading, or
   (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.


material nonpublic information in a securities transaction a violation of rule 10b-5 if the information has been obtained through the breach of a fiduciary duty. Under the misappropriation theory, the breach of any fiduciary duty will be sufficient to impose liability under rule 10b-5, whether or not the breach actually affected any parties to the securities transaction.

The expansion of rule 10b-5 liability under the misappropriation theory is not in accord with United States Supreme Court decisions. The Supreme Court has held that before rule 10b-5 sanctions may be invoked, a fraudulent breach of duty between the parties to the transaction must be proved. The misappropriation theory is in conflict with decisions of the Supreme Court concerning the scope of liability under rule 10b-5 because the misappropriation theory bases liability upon the nature of information rather than the relationship between the traders. The misappropriation theory gives the Securities and Exchange Commission (SEC) greater latitude under rule 10b-5 to curb insider trading. The Supreme Court, however, has interpreted the scope of liability under rule 10b-5 more narrowly, leaving the task of expanding the powers of the SEC to Congress.

The misappropriation theory creates a general basis for rule 10b-5 liability because liability is based upon the illegal nature of the information. The SEC has extensive regulatory powers under the misappropriation theory that, if abused, could inhibit the free flow of information in the stock markets. The possibility of a chilling effect on the flow of information would be contrary to the rationale of the 1934 Securities Act, which is to achieve full disclosure of information in the stock market.

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6. See infra notes 87-124 and accompanying text.
7. See infra notes 109-24 and accompanying text.
9. See infra notes 48-79 and accompanying text.
10. See infra notes 87-124 and accompanying text.
11. Liability under the misappropriation theory is more extensive than liability imposed by the majority holding in Chiarella; consequently, the SEC could be more active in curbing the use of illegally obtained information. See Misappropriation Theory is Adopted for 10b Inside Trading Criminal Liability, 3 The Company Lawyer 239, 240 (1982).
12. See infra notes 48-79 and accompanying text.
13. See infra notes 125-69 and accompanying text.
The purpose of this comment is to compare and contrast the misappropriation theory with the rationale of the United States Supreme Court decisions pertaining to the scope of liability under rule 10b-5 for nondisclosure of inside information. This author first will discuss the rulings that initially interpreted the scope of rule 10b-5 liability for nondisclosure. Recent United States Supreme Court decisions, which have narrowed the scope of liability under rule 10b-5, also will be discussed. The misappropriation theory and cases utilizing this theory subsequently will be analyzed. These cases then will be compared with the rationale of both the recent Supreme Court cases and recent Congressional enactments. This author will conclude that the misappropriation theory should be abandoned as a basis for imposing rule 10b-5 liability, leaving to Congress the duty to fashion regulations to remedy specific problems. Prior to this analysis, however, a brief discussion of section 10(b) and rule 10b-5 is appropriate.

**History of Rule 10b-5**

Section 10(b) of the Securities and Exchange Act of 1934 is designed to give the SEC broad powers to assure fairness and integrity in the stock market. The expansive language of section 10(b) evidences Congressional intent to guard against fraudulent manipulations of the stock market similar to those that led to the market crash of 1929. In 1942, the SEC promulgated rule 10b-5, creating a comprehensive prohibition against any "act, practice or course of business which

17. See infra notes 22-35 and accompanying text.
18. See infra notes 97-108 and accompanying text.
19. See, e.g., §14(e) and rule 14e-3 discussed infra notes 154-56 and accompanying text.
20. See infra notes 125-69 and accompanying text.
21. 15 U.S.C. §78j(b). Section 10(b) states:
   It shall be unlawful for any person... (b) to use or employ, in connection with the purchase or sale of any security, registered on the 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 [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.
Id.
would operate as a fraud or deceit upon any person in connection with the purchase or sale of securities.”

Liability under rule 10b-5 results from some form of active fraud, deceit, or misrepresentation in connection with the purchase or sale of securities. Liability for trading on nonpublic information, therefore, depends upon whether the nondisclosure constitutes fraud. Section 10(b) and rule 10b-5 provide little guidance in determining whether the nondisclosure of a material fact will constitute a violation of rule 10b-5 and section 10(b). Two early rulings from the SEC and the Second Circuit analyzed whether rule 10b-5 requires disclosure of material nonpublic information prior to trading. These cases interpreted rule 10b-5 as imposing an affirmative duty upon the traders and insiders to disclose nonpublic information before trading on the information.

The initial SEC ruling that imposed liability for nondisclosure was In re Cady, Roberts Co. In this decision, the SEC disciplined a broker for trading on inside information received from a board member of a corporation that the corporation intended to reduce dividends. The SEC declared that anyone obtaining material nonpublic information through someone who has a position as a corporate insider must disclose that information or abstain from trading in those securities.

The effect of Cady, Roberts was to expand the scope of liability under rule 10b-5 by enlarging the definition of a corporate insider to include more than directors and majority stockholders. The ruling established two prerequisites to the imposition of liability. First, a relationship affording access to inside information intended only for a corporate purpose must exist. Second, the advantage gained by the

25. 17 C.F.R. §240.10b-5.
27. See infra notes 64-79 and accompanying text.
29. See infra notes 30-42 and accompanying text.
31. Id. at 905.
32. See SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) The Court in Texas Gulf stated that information is material if a substantial likelihood exists that a reasonable man would consider the information important or if the information might affect the value of the stock. Id.; see also TSC Industries v. Northway Inc., 426 U.S. 438, 449 (1975) (definition of materiality in the context of proxy solicitations under rule 14a-9).
34. Traditionally, corporate insiders included officers, directors, and controlling stockholders. Id. at 911. The rule announced in Cady, Roberts specifically includes any person with access to inside information. Id. at 912.
insider trading on the undisclosed information must be found to be unfair.35

The Cady, Roberts "disclose or abstain" rule was expanded by the Second Circuit in the case of S.E.C. v. Texas Gulf Sulphur.36 Texas Gulf held that anyone in possession of material nonpublic information is under a duty to disclose the information to the investing public or abstain from trading in the stock of the corporation.37 The imposition of an affirmative duty upon anyone in possession of material nonpublic information is an extreme departure from the common law cause of action for misrepresentation.38 The duty to disclose traditionally is imposed upon only traders owing a duty to the corporation.39 Texas Gulf broadly extends liability because the mere possession of nonpublic information triggers the duty to abstain from trading even to persons not owing a duty to the corporation.40 Predictably, the adoption of an overinclusive duty to disclose in Texas Gulf created a deterrence to the free flow of information.41 Interpreting rule 10b-5 to proscribe all trades involving inequality of information is an unwarranted extension of liability into areas Congress did not intend the rule to cover.42

The scope of the duty to disclose under section 10(b) and rule 10b-5 is clearly unsettled. Since the promulgation of the Securities Act of 1934, Congress has not addressed the question of the scope of section 10(b).43 Absent clear guidance from Congress, judicial interpreta-

35. The ruling in Cady, Roberts involved a fiduciary duty by a corporate officer to keep corporate information confidential. Id.
36. SEC v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968); see Note, Securities Regulation, supra note 3, at 185.
37. Texas Gulf, 401 F.2d at 848.
40. See id.
42. See Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 700 (1974). "It seems anomalous to jigsaw every kind of corporate dispute into the federal courts through the securities acts as they are presently written."Id.
tion of rule 10b-5 has been inconsistent. The United States Supreme Court has addressed the issue of rule 10b-5 liability for nondisclosure in two recent cases, *Chiarella v. United States* and *Dirks v. United States*. Liability for nondisclosure under rule 10b-5 was limited in these decisions to those instances in which the nondisclosure constituted fraud.

**United States Supreme Court Decisions Regarding Nondisclosure**

The scope of the "disclose or abstain" rule and liability for trading with material nonpublic information first was addressed by the United States Supreme Court in *Chiarella v. United States*. In *Chiarella*, the Court held that liability for trading with material nonpublic information was limited to those persons who owed a fiduciary duty to a party to the sale. *Chiarella*, a mark-up man for a financial printer in New York City, had access to confidential information regarding upcoming tender offers. The offering corporation would give the information to the printing house, disguised by false names, numbers, and blank spaces, to be prepared for dissemination to the public. *Chiarella* handled five planned transactions in which he was able to ascertain the target companies and use the confidential information to buy the stock of the companies. *Chiarella*'s trading netted him more than $30,000 in fourteen months.

The SEC investigated, and *Chiarella* subsequently was indicted on criminal charges for violating rule 10b-5. The jury found *Chiarella* guilty of securities fraud because he had traded in the securities market without disclosure of all material nonpublic information. The Second Circuit Court of Appeals affirmed the conviction, holding that all persons who have regular access to material nonpublic informa-

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46. 103 S. Ct. 3255 (1983).
47. *Id.* at 3263; *Chiarella*, 445 U.S. at 235.
49. *Id.* at 235.
50. *Id.* at 224. A mark-up man designs and prepares financial documents. *Id.* To prepare the documents, the information must be given sometime before a tender offer or merger plan is made public. *Id.*
51. *Id.*
52. Four of the transactions were tender offers and one was a merger attempt. *Id.*
54. *Chiarella*, 445 U.S. at 236. *Chiarella* also was required to return the profits to the sellers of the stock. *Id.* at 236.
tion have an affirmative duty to disclose before trading on the nonpublic information.\(^\text{55}\)

On certiorari,\(^\text{56}\) the United States Supreme Court expressly rejected the theory that rule 10b-5 imposes a duty to disclose based upon the mere possession of nonpublic information.\(^\text{57}\) Building upon the common law requirements for fraud, the Court held that a relationship of trust and confidence between the buyers and the sellers of securities must exist before an affirmative duty to disclose material nonpublic information may be imposed.\(^\text{58}\) The Second Circuit ruling was reversed because liability had been imposed without requiring a breach of a fiduciary relationship to a party involved in the transaction.\(^\text{59}\)

The holding in \textit{Chiarella} limited the expansion of liability under rule 10b-5. The United States Supreme Court found no evidence of Congressional intent to broadly prohibit trading with nonpublic information.\(^\text{60}\) Instead, the Court took notice of the detailed and sophisticated rules promulgated by Congress to regulate the securities market as an indication of the intent to limit the scope of rule 10b-5 liability.\(^\text{61}\) An interpretation of rule 10b-5 that imposes liability without a fiduciary duty involved conflicts with previous limited enactments of Congress concerning nondisclosure.\(^\text{62}\)

The holding in \textit{Chiarella}, which limited the scope of rule 10b-5 to those instances involving a breach of a confidential or fiduciary relationship,\(^\text{63}\) was reinforced by the United States Supreme Court in \textit{Dirks v. United States}.\(^\text{64}\) Dirks was an investment analyst of insurance company securities for institutional investors.\(^\text{65}\) Dirks received information from a former officer of Equity Funding of America that an extensive fraud was being perpetrated by Equity Funding against the investors in the fund.\(^\text{66}\) Dirks investigated the charges and, although

\(^{55}\) Chiarella v. SEC, 588 F.2d 1358 (2d Cir. 1978).

\(^{56}\) 441 U.S. 942, No. 78-1202 (1978).


\(^{58}\) See id. at 235.

\(^{59}\) See id. at 233.

\(^{60}\) \textit{Id.}

\(^{61}\) \textit{Id.}

\(^{62}\) \textit{Id.} at 234. The Court also noted that Congressional action in the area of securities fraud has been very limited and specific, with no broad prohibitions enacted. \textit{Id.}

\(^{63}\) \textit{Id.} at 235. The United States Supreme Court declined to rule on the alternative theory advanced by the SEC in \textit{Chiarella} that the breach of duty by Chiarella to his employer satisfied the rule 10b-5 requirement of "fraud in connection with the sale or purchase of securities." \textit{Id.} at 236.

\(^{64}\) 103 S. Ct. 3255 (1983).

\(^{65}\) \textit{Id.} at 3258.

he could not find any concrete proof of fraud, the allegations were corroborated by lower level employees.  

Neither Dirks nor his employer owned any stock in Equity Funding, but Dirks advised clients and other advisors to sell their Equity Funding securities. As a result, $16 million worth of Equity Funding securities were sold, resulting in a decline in the value of that stock. Trading in Equity Funding was halted and the SEC investigated, uncovering evidence of a massive fraud. Dirks also was investigated and subsequently indicted for securities violations, including fraud for non-disclosure of material nonpublic information under rule 10b-5.

At trial, the SEC urged the court to hold that anyone who knowingly receives nonpublic material information from an insider has a duty to refrain from trading on the information. The administrative court convicted Dirks of violating rule 10b-5 after adopting the SEC standard. The basis for the conviction was the use of material nonpublic information in tipping others of the fraud at Equity Funding. On certiorari, the United States Supreme Court rejected this theory, relying upon the holding in Chiarella that the mere receipt of nonpublic information from an insider will not create a duty to disclose the information. The Court held that the following elements must be established: (1) a violation of an existing fiduciary duty to the corporation or to the shareholders by the tippor; (2) the information must be given to the tippee for personal gain; and (3) the tippee must have knowledge of the fiduciary breach.

For the nondisclosure by the tippee to be actionable as fraud, a breach of a fiduciary duty by the tippor constituting fraud would be required. Dirks received the information from an insider at Equity Funding who had tipped the information without any intent to gain personally or defraud the shareholders. The Supreme Court held that no fraud can exist, even if a breach of fiduciary duty is shown,
unless the violation of a confidential relationship is for personal gain. The tipping to Dirks did not constitute a violation of rule 10b-5 because the tipping was not done for personal gain and, therefore, no fraud was perpetrated.

The rationale of the United States Supreme Court in Chiarella and Dirks indicates that general liability cannot attach for nondisclosure based solely upon the use of nonpublic information. In addition to the mere use of this information, a fraudulent breach of duty must be shown. The majority of the Court in Chiarella declined to rule on the misappropriation theory advanced by the SEC. Chief Justice Burger, dissenting in Chiarella, approved of the imposition of an affirmative duty to disclose or abstain from trading with any material nonpublic information illegally obtained through breach of a duty to an employer. According to Chief Justice Burger, liability should not be based solely upon the breach of a fiduciary duty to the corporation or party involved in the buying or selling of stock. Certain lower federal courts, notably the Second Circuit, have adopted the reasoning of the dissent in Chiarella to avoid the limitations imposed by the majority opinion.

The rationale of Chiarella and Dirks prohibit imposition of liability under rule 10b-5 on the sole basis of trading with material nonpublic information. The propriety of the misappropriation theory has not been addressed directly by the United States Supreme Court; the question has been expressly left open in Dirks and Chiarella. Use of the misappropriation theory as a basis for rule 10b-5 liability, however, is inconsistent with the rulings of that Court. Nonetheless, two Second Circuit cases decided since Chiarella have relied upon a breach of duty by an employee to satisfy the fraud requirement for prosecution under rule 10b-5.

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79. Id. at 3266.
80. See id.; Chiarella, 445 U.S. at 232-33, see also, Comment, supra note 28, at 1013; Note, supra note 26, at 320.
81. Chiarella, 445 U.S. at 236.
82. Id. at 240 (Burger, C.J., dissenting).
83. Id.
84. In addition to the Second Circuit cases discussed infra notes 97-108 and accompanying text, the misappropriation theory has been used by other federal courts. See e.g., SEC v. Blavin, 557 F. Supp. 1304 (E.D. Mich. 1983). But see Feldman v. Simkins Industries, 492 F. Supp. 839 (N.D. Cal. 1980) (following the holding of the majority in Chiarella).
85. See supra notes 48-79 and accompanying text.
86. The use of the misappropriation theory is not exclusive to the Second Circuit. See supra note 84.
The Misappropriation Theory

In the Second Circuit, trading on illegally obtained nonpublic information constitutes a violation of rule 10b-5. To date, liability for the use of misappropriated information has been based upon the breach of a fiduciary duty to an employer by an employee to keep client information confidential. Liability is not necessarily limited to breaches of fiduciary duties by corporate insiders, buyers or purchasers of securities. Consequently, the misappropriation theory expands the scope of liability for nondisclosure imposed by the Supreme Court in Dirks and Chiarella. The misappropriation theory allows a breach of a fiduciary duty that is unrelated to the actual sales transaction to trigger the duty to disclose or abstain from trading with material nonpublic information.

Under the misappropriation theory, liability attaches because the use of illegal information acts as a "fraud on the market" in contrast to fraud being perpetrated against a particular purchaser or seller of stocks. The fraud-on-the-market rationale does not require a breach of a fiduciary duty to a party, in connection with a transaction in securities, to establish liability under section 10(b) and rule 10b-5. Under this rationale, the use of misappropriated information is unfair and exploitative of the market. The misappropriation theory, in effect, nullifies the holding in Chiarella by establishing a duty to disclose based upon the character of the information rather than the duty to a particular person or organization.

In cases since Chiarella, the Second Circuit has utilized the misappropriation theory to impose liability upon those who trade with
illegally obtained or misappropriated market information. The first case to employ the misappropriation theory to impose liability under rule 10b-5 was *U.S. v. Newman*. Newman received confidential and misappropriated information from two employees of investment banking firms concerning takeover and merger attempts by the clients of the firm. Newman, a securities trader, passed the information to others who, in turn, used foreign bank accounts and a variety of securities brokers to buy up the stock of the target companies. The Second Circuit held that Newman had violated rule 10b-5 by using confidential information obtained in breach of a fiduciary duty to the employers of the tippers. Criminal liability was imposed under rule 10b-5 in *Newman*, for the use of confidential, nonpublic information obtained through a breach of a fiduciary duty, even though that duty was unrelated to the actual transaction.

A 1984 case decided by the Second Circuit has reaffirmed the misappropriation theory established in *Newman*. *SEC v. Materia* involved a factual situation very similar to *Chiarella*. Materia worked as a copyholder for a large New York financial printing house. Using his position, Materia was able to ascertain the identities of four firms soon to be involved in takeover attempts. Materia acquired almost $100,000 by trading on the basis of confidential information misappropriated from the clients of his employer. The court, in finding Materia to have violated rule 10b-5, relied upon the ruling in *Newman* that "anyone who misappropriates nonpublic information in breach of a fiduciary duty and trades on such information to his own advantage violates Section 10(b) and rule 10b-5." The misappropriation theory, as articulated in *Newman* and *Materia*, imposes liability for the use of any nonpublic and illegally obtained inside information. The Supreme Court in *Chiarella* and *Dirks*,

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97. 664 F.2d 12 (2d Cir. 1981).
98. Id. at 15.
99. Id.
100. Id. at 17.
101. Id. at 16.
102. 745 F.2d 197 (2d Cir. 1984).
103. *Chiarella* 445 U.S. at 224. See supra notes 48-63 and accompanying text.
104. *Materia*, 745 F.2d at 199. A copyholder reads the copy of the financial document to a proofreader. Id.
105. Id.
106. Id.
107. Id. at 194.
108. Id. at 201.
109. See id.; *Newman*, 664 F.2d at 17; see also supra notes 97-101 and accompanying text.
however, employed a more limited scope of liability under rule 10b-5. Specifically, the Supreme Court rejected the holding of Texas Gulf, which imposed liability whenever security transactions involved the use of nonpublic information, holding that fraud in connection with a securities transaction is a prerequisite to rule 10b-5 liability. The rationale in Chiarella and Dirks indicates that liability for the use of nonpublic information under rule 10b-5 is premised upon the relationship between the parties to the securities transaction. Following Chiarella, liability is limited to those situations in which the buyer or seller has been defrauded. Extensive liability for nondisclosure could result in a chilling effect on the dissemination of information that allows for an efficient market. For example, in Dirks, the market reaction to the inside information was responsible for bringing the Equity Funding fraud to light. If Dirks had not divulged the inside information about Equity Funding, the fraud would have continued. Complete information is required to enable participants in the stock market to set prices equal to actual value of the stock. Limiting the use of nonpublic information may hinder legitimate and helpful stock market practices such as the detection of mismanagement or fraud that occurred in Dirks.

In contrast, the misappropriation theory focuses on the elimination of unfair advantages by emphasizing the illegal and nonpublic character of the information. The misappropriation theory does not base rule 10b-5 liability on the Chiarella theory of fraudulent nondisclosure. Instead, liability is premised upon the misuse or unethical manipulation of the stock market. The misappropriation theory allows the SEC to utilize rule 10b-5 to punish traders who take advantage of the stock market by using stolen information.

110. See supra notes 48-79 and accompanying text.
111. See Chiarella, 445 U.S. at 233.
112. Chiarella, 445 U.S. at 232-33; Dirks, 103 S. Ct. at 3261.
114. See Morrison, supra note 44, at 218 (quoting from the amicus brief filed in Chiarella by the securities industry outlining five areas that might be considered illegal under a general liability standard); Note, The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry, 29 STAN. L. REV. 1031, 1055-56 (1977).
115. See Dirks, 103 S. Ct. at 3259, n. 8.
116. See id.
117. See Note, supra note 114, at 1056; Kerr, supra note 41, at 823.
118. Dirks, 103 S. Ct. at 3261; Chiarella, 445 U.S. at 231-32, n. 14; see Note, supra note 26, at 331.
119. See Newman, 664 F.2d at 17. Liability under the misappropriation theory turns upon the existence of fraud to an employer. Id. Since, however, there is no breach of duty to a party actually injured by the nondisclosure, the fraud rationale is only a means of circumventing Chiarella. Note, supra note 8 at 734. See also Note, supra note 90, at 863.
120. See supra notes 97-101 and accompanying text; see also Newman, 664 F.2d at 17.
121. See Note, supra note 8, at 740.
The misappropriation theory attempts to ensure a fair market by promoting equality of information among all traders.\(^{122}\)

Rule 10b-5 should insure fairness without arbitrarily impeding the efficiency of the market. Although these aims are conflicting, care must be taken to accommodate both of them. The imposition of liability based upon the illegal character of the information alone sacrifices market efficiency by limiting the disclosure of important market information.\(^{123}\) The chilling effect of the misappropriation theory on the stock market illustrates that the theory is an inappropriate vehicle to ensure the dual aims of rule 10b-5.\(^{124}\)

**The Adverse Effects of the Misappropriation Theory**

*Chiarella* and *Dirks* narrowly interpreted the scope of rule 10b-5, requiring the breach of a fiduciary duty in connection with the sale or purchase of securities as a prerequisite to rule 10b-5 liability.\(^{125}\) Consistent with this narrow interpretation, Congress enacted section 14(e), which prohibits the use of inside information only when the information concerns tender offers.\(^{126}\) The limited scope of section 14(e) indicates a Congressional policy favoring specific and narrow rules for nondisclosure.\(^{127}\) In contrast, the misappropriation theory supplies a broad basis for rule 10b-5 liability by classifying the use of information obtained through any breach of a fiduciary duty as fraudulent.\(^{128}\)

The effects of limitations imposed by the misappropriation theory are counterproductive to the aims of equality of information and fairness. Unnecessary limitations on the dissemination of information impairs the efficiency of the market by lowering the total pool of available information.\(^{129}\) Additionally, broad liability for the use of inside information will create a more inequitable market because, by restricting the flow of information, no incentive is present to disseminate important market information and only the top analysts are privy to the information.\(^{130}\)

\(^{122}\) *Id.*


\(^{124}\) See *infra* notes 157-63 and accompanying text.

\(^{125}\) See *supra* notes 48-79 and accompanying text.

\(^{126}\) *Chiarella*, 445 U.S. at 233; *see also* 15 U.S.C. §78m(d)(I) (allows tender buyer to obtain 5% before disclosing takeover plan).

\(^{127}\) *Chiarella*, 445 U.S. at 233, n.16.

\(^{128}\) See *supra* notes 87-124 and accompanying text.


In *Chiarella*, the United States Supreme Court recognized that section 10(b) was a "catch all" section, but stated that "what it catches must be fraud." 131 Under the misappropriation theory, the fraud requirement is satisfied by *any* breach of fiduciary duty. 132 In *Santa Fe Ind. v. Green*, 133 however, the Supreme Court held that not every breach of a fiduciary duty will be considered fraud. 134 Consequently, a nonfraudulent breach of duty cannot support an action under rule 10b-5. 135

*Santa Fe* held that a violation of section 10(b) must involve a deceptive or manipulative practice used to defraud a party to a securities transaction. 136 In *Santa Fe*, the defendant corporation was accused of violating section 10(b) and rule 10b-5 for trying to freeze out 137 the minority shareholders of Kirby Lumber Company. 138 The Santa Fe corporation, a majority shareholder, wanted to acquire 100% of Kirby Lumber by forcing the minority shareholders to agree to a buy-out. 139 The minority shareholders argued that they were being forced to accept an offer that had been arrived at in violation of the fiduciary duty owed by the majority shareholder to the other shareholders of Kirby Lumber. 140 The Court held that more than a mere breach of a fiduciary duty is necessary to violate rule 10b-5; deception, misrepresentation, or fraudulent nondisclosure in connection with the sale also must be proved. 141 The decision in *Santa Fe* clearly established that not every breach of a fiduciary duty will be actionable as securities fraud. 142 The Supreme Court in *Santa Fe* gave a limited reading to the language of rule 10b-5. 143 The Court in *Santa Fe* refused to adopt a body of case law that could be interpreted so broadly that the workings of the securities markets could be impeded. 144

The rationale for liability under the misappropriation theory is
that rule 10b-5 prohibits any use of fraudulent or deceptive manipulation in connection with the purchase or sale of securities. The use of information that has been misappropriated from an employer can constitute the fraud required for liability under this theory. The misappropriation theory bases liability on the misappropriation of information rather than nondisclosure of information. The misappropriation theory, however, does not account for the fact that a breach of a duty to an employer is not always fraudulent. The theft of confidential information may be illegal and morally reprehensible, but may not fall under the prohibitions against fraud in rule 10b-5 because the actual market transaction was accomplished between two parties in an arms length deal. The misappropriation theory is not founded upon a breach of duty to the buyers or sellers of securities, but upon the fact that the information was obtained through illegal means.

Rule 10b-5 and section 10(b) were not intended to regulate the type of information used in the securities transactions. Instead, these provisions were intended to regulate the relationship between the parties engaged in the transactions.

The misappropriation theory erects rule 10b-5 as a barrier to the use of any illegally obtained inside information. The United States Supreme Court, however, narrowly limits the use of rule 10b-5 to cases that constitute fraud, leaving Congress to establish detailed regulations concerning the use of illegally obtained information. Congress responded to the misuse of information regarding tender offers by enacting narrow prohibitions against the use of any confidential information. These prohibitions are embodied in a new section to the Securities and Exchange Act and rule 14e-3 that expressly prohibits anyone from exploiting the market by using confidential information concerning tender offers. This action illustrates that Congress recognizes the problem of the scope of liability under rule 10b-5 and is willing to remedy the problem by specific legislation.

Section 14(e) addresses the narrow problem of the misuse of infor-

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145. See supra notes 87-124 and accompanying text.
146. Block & Barton, supra note 123, at 353; Note, supra note 28, at 1024.
147. See supra notes 48-63 and accompanying text.
148. See supra note 113.
149. See Note, supra note 8, at 734; see generally Block & Barton, supra note 123.
150. See Chirello, 445 U.S. at 234; and see notes 48-63 and accompanying text.
151. See Block & Barton, supra note 123, at 364-65.
152. See supra notes 80-86 and accompanying text.
153. 15 U.S.C. §78n(e). Section 14(e) and the corresponding rule 14e-3 prohibits any untrue statement or omission in connection with a tender offer. See 17 C.F.R. §240.14e-3.
154. Id.; see Block & Barton, supra note 123, at 371.
mation regarding tender offers. The section therefore will not unduly affect the flow of information in the stock market. Section 14(e) evidences Congressional intent to maintain the credibility of the stock market. Furthermore, the narrow scope of the statute indicates that Congress intended not to unduly impede the workings of the marketplace.\textsuperscript{155} The misappropriation theory, in stark contrast to the intent of Congress attempts to give the SEC wide latitude in policing the securities market. The possible cost of a wide prohibition on the use of nonpublic information in securities transactions, however, outweighs the benefits to be gained by equalizing trader access to inside information.\textsuperscript{156}

Promoting equality of information in the securities market by prohibiting use of misappropriated information will not ensure equality because the theory discourages disclosure of information instead of encouraging disclosure. Extensive liability for disclosing information merely decreases the number of people who have access to such information.\textsuperscript{157} As noted, traders who have inside market information that would benefit other traders will not disclose the useful information.\textsuperscript{158} Influential traders, market professionals, and analysts will solidify their market position by holding a virtual monopoly on market information, tips, and gossip.\textsuperscript{159} Concentration of information in fewer hands facilitates exploitation of the market rather than fairness.

Certain uses of nonpublic, illegally obtained information, however, clearly are unfair and manipulative of the stock market.\textsuperscript{160} Rule 10b-5 is not designed specifically to differentiate useful nonpublic information from manipulative uses of nonpublic information.\textsuperscript{161} What is important to understand is that inside or nonpublic information alone does not undermine the confidence in the market or violate the trust shareholders have in corporate directors.\textsuperscript{162} The free flow of information is essential to the successful operation of the market; moreover,
the use of nonpublic information can be helpful in preventing fraud, since the market participants are more informed.\textsuperscript{163}

An expansive interpretation of rule 10b-5 may reach the best solution in certain situations. Illegal practices of the type used by the defendants in \textit{Chiarella},\textsuperscript{164} \textit{Newman},\textsuperscript{165} and \textit{Materia}\textsuperscript{166} clearly are unfair and should be prohibited. Rule 10b-5, however, is not the best means to achieve this end. Rule 10b-5 was not designed to combat every unfair situation accompanying securities transactions.\textsuperscript{167} Only those situations that include a breach of a fiduciary relationship were intended to be proscribed.\textsuperscript{168} Consequently, the misappropriation theory should be abandoned as a basis for liability under rule 10b-5 and section 10(b). This theory conflicts with the rationale of the Supreme Court as expressed in \textit{Chiarella} and \textit{Dirks} and exposes rule 10b-5 as an inadequate tool for distinguishing useful nonpublic information from the purely unfair.\textsuperscript{169}

\textbf{Conclusion}

This author has outlined the two major judicial interpretations of the limitations imposed by section 10(b) of the Securities and Exchange Act of 1934 and rule 10b-5 with respect to the duty to disclose nonpublic information before trading in the stock market. The United States Supreme Court in \textit{Santa Fe}, \textit{Chiarella}, and \textit{Dirks} has premised rule 10b-5 liability upon common law fraud principles that require a fiduciary relationship between the parties before a duty to disclose arises. The United States Supreme Court expressly rejected the imposition of 10b-5 liability in the absence of a confidential relationship. In contrast, the misappropriation theory imposes a duty to disclose on all those who trade upon illegally obtained, material nonpublic information.

\textsuperscript{163} The use of inside information by Raymond Dirks forced the SEC to investigate Equity Funding and uncover the massive fraud. \textit{Dirks}, 103 S. Ct. at 3259-60. Without the market reaction to the dissemination of the inside information, the fraud may have gone undetected. \textit{Id}.

\textsuperscript{164} Chiarella divined the targets of takeover attempts from the financial documents he prepared for his employer. \textit{Chiarella}, 445 U.S. at 224.

\textsuperscript{165} Newman received confidential information concerning takeover attempts from employees of investment banking firms. \textit{Newman}, 664 F.2d at 15. Newman would then pass the stolen information to other traders. \textit{Id}.

\textsuperscript{166} Materia, in his position as a copyholder, was able to deduce the identity of four corporations that were targets of upcoming tender offers. \textit{Materia}, 745 F.2d at 199.

\textsuperscript{167} \textit{But see Anderson}, supra note 160 at 373-77. The analysis recognizes the problems with 10b-5 as currently interpreted, but would propose to judicially tailor rule 10b-5 instead of relying on Congressional action. \textit{Id}.

\textsuperscript{168} \textit{See Dirks}, 103 S. Ct. at 3262-63; \textit{Chiarella}, 445 U.S. at 235.

\textsuperscript{169} \textit{See Block & Barton}, supra note 123, at 364; Note, supra note 90, at 866; Second Circuit Expansion, supra note 3, at 426.
The interpretation of section 10(b) and rule 10b-5 under the misappropriation theory is inconsistent with the rationale of the United States Supreme Court decisions. The requirement of fraud in connection with the sale or purchase of securities is missing under the misappropriation theory because a general duty to disclose merely upon possession of illegally obtained information is imposed. The misappropriation theory is an attempt to insure a more equitable and fair market through absolute equality of information in the stock market. The Supreme Court, however, has refused to allow the promotion of fairness through excessive restrictions on the workings of the market, as illustrated in both Chiarella and Dirks.

The misappropriation theory imposes excessive liability and conflicts with the United States Supreme Court interpretation of section 10(b) and rule 10b-5. Consequently, the misappropriation theory must be rejected as a theory of liability for violations of rule 10b-5. The stock market likely will be affected adversely by adherence to an interpretation of section 10(b) and rule 10b-5 that requires all inside information used in the trading of securities be equally available to all investors. The intricacies of the securities market cannot be regulated through a general prohibition on the use of misappropriated inside information. The Supreme Court has elected to relegate to Congress the responsibility of detailing specific regulations necessary to insure the integrity of the market without disruption. The securities market functions well with a minimum amount of uncertainty and a maximum amount of information. The misappropriation theory increases uncertainty and decreases the pool of available information. Intelligent and detailed Congressional action is the best way to ensure that the delicate task of separating the harmful from the helpful inside information is accomplished.

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