

2-1-1991

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Recommended Citation

Thomas L. Hazen, *United States v. Chestman - Trading Securities on the Basis of Nonpublic Information in Advance of a Tender Offer*, 57 Brook. L. Rev. 595 (1991).

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UNITED STATES *v.* CHESTMAN*—
TRADING SECURITIES ON THE BASIS OF
NONPUBLIC INFORMATION IN ADVANCE OF
A TENDER OFFER

*Thomas Lee Hazen***

BACKGROUND

The law should and does impose limits upon the extent to which corporate insiders (as well as others who are in possession of material nonpublic information) can take advantage of their special knowledge by trading in securities.¹ Although there are some commentators who do not agree,² the majority of observers believe that trading on nonpublic information gives an unfair advantage to corporate insiders and thus is properly prohibited.³

Nowhere in either the text of the federal securities acts or in the rules and regulations of the Securities and Exchange Commission (SEC) is there a definition of the precise scope of illegal trading in securities on the basis of material nonpublic information. Nevertheless, since 1961,⁴ and especially in recent years, the SEC has enjoyed enormous success in challenging improper

* 903 F.2d 75 (2d Cir. 1990), *rev'd in part, aff'd in part*, No. 89 Civ. 1276 (Oct. 7, 1991) (in banc).

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¹ See generally 2 T. HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* § 13.9 (2d ed. 1990).

² E.g., H.O. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Carney, *Signaling and Causation in Insider Trading*, 36 CATH. U.L. REV. 863 (1987).

³ See Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School"*, 1986 DUKE L.J. 628; Cox, *Insider Trading Regulation and the Production of Information: Theory and Evidence*, 64 WASH. U.L.Q. 475 (1986); Hazen, *Corporate Insider Trading: Reawakening the Common Law*, 39 WASH. & LEE L. REV. 845 (1982); Hazen, *Commentary*, 36 CATH. U.L. REV. 937, 993-996 (1987); Schotland, *Unsafe at Any Price: A Reply to Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967).

⁴ The first successful use of the securities laws to combat insider trading took place in an SEC administrative proceeding against a broker-dealer. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

trading on nonpublic information.⁵ In addition, in 1984 and in 1988 Congress enacted legislation aimed at increasing the effectiveness of governmental enforcement efforts to both sanction and deter insider trading⁶ and further created an express private right of action for contemporaneous traders.⁷

In *United States v. Chestman*⁸ a three judge panel of the Second Circuit handed down a decision presenting a narrow view of the securities laws' reach with regard to insider trading. Subsequently, on rehearing in banc, the full court fashioned a broader interpretation.⁹ Specifically, *Chestman* addressed the applicability of the securities laws to remote recipients of nonpublic information (tippees) who trade on nonpublic information.

I. THE SOURCES OF INSIDER TRADING PROHIBITIONS

There are two rules¹⁰ promulgated under the Securities Exchange Act of 1934¹¹ that have been used to combat improper

⁵ See, e.g., *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd in part and aff'd in part by an equally divided Court*, 484 U.S. 19 (1987) (conviction of Wall Street Journal reporter and friends for violations of the securities laws and the federal Mail Fraud Act; the securities conviction was affirmed by an equally divided Court while the mail fraud conviction was unanimously affirmed); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985) (printer violated Rule 10b-5 by trading on nonpublic information obtained from client). The success in the courts has helped lead to several lucrative and highly publicized settlements. See, e.g., *SEC v. Kidder Peabody & Co.*, 19 Sec. Reg. & L. Rep. (BNA) 811 (S.D.N.Y. 1987) (settlement of more than \$25,000,000); *SEC v. Boesky*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. 1986) (settlement of \$50,000,000 disgorgement of profits plus a \$50,000,000 civil penalty).

⁶ See The Insider Trading Sanctions Act of 1984 ("ITSA"), Pub. L. No. 98-376, 98 Stat. 1264 (Aug. 24, 1984); 15 U.S.C. § 78u-1 (1988). See generally Langevoort, *Commentary—The Insider Trading Sanctions Act of 1984 and its Effect on Existing Law*, 37 VAND. L. REV. 1273 (1984).

⁷ See The Insider Trading and Securities Fraud Enforcement Act of 1988 ("IT-SFEA"), Pub. L. No. 100-704, 102 Stat. 4677 (Nov. 19, 1988); 15 U.S.C. § 78t-1 (1988).

⁸ 903 F.2d 75 (2d Cir. 1990), *rev'd in part, aff'd in part*, No. 89 Civ. 1276 (Oct. 7, 1991) (in banc).

⁹ *Id.*

¹⁰ In addition to the two rules discussed directly below in the text, section 16(b) of the Exchange Act provides for disgorgement of shortswing profits by officers, directors and ten percent beneficial owners of publicly held corporations. 15 U.S.C. § 78p(b) (1988). Section 16(b), which is discussed in the text accompanying notes 62-63 *infra*, is a prophylactic rule which is not dependent upon either possession or use of nonpublic information.

¹¹ 15 U.S.C. §§ 78a-78ll (1988).

insider trading. SEC Rule 10b-5¹² deals with fraud in the purchase or sale of securities generally, while Rule 14e-3¹³ speaks directly to persons who trade on the basis of nonpublic information pertaining to a pending or anticipated tender offer. The three judge panel in *Chestman* ruled that neither of these rules applied to remote tippees. In so ruling, the panel was unanimous as to the Rule 10b-5 issue but was split three ways on the applicability and validity of Rule 14e-3. The full court viewed the issues as sufficiently significant to warrant a rehearing in banc. After several months of deliberations, the full court reinstated the Rule 14e-3 convictions while affirming the panel's rejection of the Rule 10b-5 and mail fraud claims.¹⁴ The three judge panel was sharply divided on the Rule 14e-3 issue but at the same time was unanimous on the Rule 10b-5 claim. In contrast, the full court rejected the 10b-5 claim by a narrow six to five margin while voting ten to one in favor of reinstating the Rule 14e-3 conviction. As these divisions demonstrate, both the Rule 10b-5 and Rule 14e-3 claims presented difficult questions on the federal law of insider trading.

The federal law of insider trading has been developed piecemeal by the SEC and the courts over a period of more than thirty years. The use of the securities laws' general antifraud proscriptions as weapons against insider trading is a relatively new phenomenon. There is no evidence that when Congress enacted section 10(b) of the 1934 Act,¹⁵ it intended to address the problem of insider trading.¹⁶ Similarly, Rule 10b-5 was not aimed directly at the problem; the rule was promulgated in one day as an attempt to craft a regulation to cover fraud in the purchase of securities.¹⁷ Rule 10b-5 existed for nineteen years

¹² 17 C.F.R. § 240.10b-5 (1990). See note 15 *infra*.

¹³ 17 C.F.R. § 240.14e-3 (1990). See note 27 *infra*.

¹⁴ *United States v. Chestman*, No. 89 Civ. 1276 (2d Cir. Oct. 7, 1991) (in banc).

¹⁵ 15 U.S.C. § 78j(b) (1982). For an excellent history of section 10(b), see Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 *STAN. L. REV.* 385 (1990).

¹⁶ In fact, section 16(b) of the Exchange Act (15 U.S.C. § 78p(b)) addresses the issue directly by requiring disgorgement of all profits obtained by officers, directors, and ten percent beneficial owners of a class of equity securities subject to the Exchange Act's reporting requirements. See Hazen, *The New Pragmatism Under Section 16(o) of the Securities Exchange Act of 1934*, 54 *N.C.L. REV.* 1 (1975).

¹⁷ Section 17(a) of the Securities Act of 1933 prohibits fraud and material misrepresentations in connection with the "offer or sale" of a security and thus cannot be invoked

before the SEC applied it to an insider trading case. In *Cady, Roberts & Co.*¹⁸ the Commission imposed sanctions against a registered broker-dealer who, while in possession of information concerning a planned dividend cut, directed his customers to liquidate their holdings. The Commission held that this conduct "violated [Rule 10b-5(3)] as a practice which operated . . . as a fraud or deceit upon the purchasers."¹⁹ It was explained that:

Analytically, the obligation [to disclose the information or abstain from trading] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.²⁰

The next significant development in the application of Rule 10b-5 to insider trading was the Second Circuit's decision seven years later in *SEC v. Texas Gulf Sulphur Co.*,²¹ wherein the court held that non-insiders who were in possession of nonpublic

against someone who commits fraud in the purchase of a security. 15 U.S.C. § 77q(a) (1982). As explained by a participant in the Rule 10b-5 drafting process:

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?"

That is how it happened.

Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793, 922 (1967) (quoting Milton V. Freeman).

¹⁸ 40 S.E.C. 907 (1961).

¹⁹ *Id.* at 913.

²⁰ *Id.* at 912 (footnotes omitted).

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

information were subject to the same disclose-or-abstain rule as articulated in *Cady, Roberts*. Following the *Texas Gulf Sulphur* decision there was a proliferation of both private actions and SEC enforcement actions under Rule 10b-5 to curtail insider trading. The Second Circuit continued to expand the use of Rule 10b-5 in insider trading cases. Thus, for example, it permitted open-market purchasers to recover from persons selling their stock with advance knowledge of an impending earnings decline.²²

The heyday of Rule 10b-5 in the Second Circuit was *Chiarella v. United States*.²³ In *Chiarella* a financial printer who was working on a tender offer document figured out the identity of the target company and then purchased stock in advance of the announcement of the offer. The court held that the printer knew that the information was nonpublic and that trading while in knowing possession of nonpublic information violated Rule 10b-5. The Supreme Court reversed the conviction, with a majority of the Justices in agreement that the mere knowing possession of material insider information was not sufficient to trigger the disclose-or-abstain duty. However, the opinion of the Court and an apparent majority of the Justices indicated that if it could be shown that a defendant misappropriated or converted confidential information that had been given to him or her while in a position of trust or confidence, Rule 10b-5 liability could attach.²⁴ Subsequently, all of the courts facing the issue accepted the misappropriation theory of liability.²⁵ When misappropriation finally reached the Su-

²² *Shapiro v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974). *Accord Elkind v. Liggett & Meyers, Inc.*, 635 F.2d 156 (2d Cir. 1980). The *Shapiro* rule subsequently was discredited in *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

²³ 588 F.2d 1358 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980).

²⁴ 445 U.S. at 230.

²⁵ *E.g.*, *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided Court*, 484 U.S. 19 (1987); *SEC v. Clark*, 699 F. Supp. 839 (W.D. Wash. 1989); *SEC v. Musella*, 678 F. Supp. 1060 (S.D.N.Y. 1988); *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) (same case). *See also, e.g.*, *SEC v. Ingram*, 694 F. Supp. 1437 (C.D. Cal. 1988). The Supreme Court tacitly approved the misappropriation theory in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 313 n.22 (1985). *See generally* Aldave, *The Misappropriation Theory: Carpenter and its Aftermath*, 49 OHIO ST. L.J. 373 (1988).

For other cases approving the misappropriation theory see *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990) (upholding indictment of psychiatrist who traded on

preme Court, a conviction based upon misappropriation was affirmed by an equally divided Court.²⁶

On the heels of the *Chiarella* decision, the SEC promulgated Rule 14e-3. Rule 14e-3 provides that anyone (other than a person making a tender offer) who purchases a security with knowledge of a planned tender offer and knows or has reason to know that the information is nonpublic commits a "fraudulent, deceptive, or manipulative act."²⁷ The clear purpose of the rule

information obtained in course of physician/patient relationship); *United States v. Willis*, 22 Sec. Reg. & L. Rep. (BNA) 996 (S.D.N.Y. 1990) (same case) (defendant psychiatrist plead guilty to insider trading charges); *SEC v. Peters*, 735 F. Supp. 1505 (D. Kan. 1990) (misappropriation doctrine could be applied to partner of investment consulting firm); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989) (upholding indictment against lawyer for allegedly misappropriating confidential client information belonging to law firm/employer); *SEC v. Musella*, 748 F. Supp. 1028 (S.D.N.Y. 1989) (employee of printer held accountable for misappropriation), *aff'd*, 898 F.2d 138 (2d Cir. 1990), *cert. denied*, 111 S. Ct. 57 (1990). *Cf. Wimberg v. Ohio Deposit Guarantee Fund*, 716 F. Supp. 1043 (S.D. Ohio 1989) (duty to disclose cannot be premised on mere possession of non-public market information; there must be a fiduciary or other similar relationship of trust and confidence).

²⁶ *United States v. Carpenter*, 484 U.S. 19 (1987). In *Carpenter* a reporter for the Wall Street Journal had advanced information as to the publication date of the "Heard on the Street" column that he authored. On several occasions he tipped his roommate and others about upcoming favorable comments that would appear in the column about selected stocks. These tippees in turn purchased the stocks, reaping a profit when the columns were published. The Second Circuit upheld a conviction of the columnist and his tippees based on the fact that the columnist had misappropriated from Dow Jones (the publisher of the Wall Street Journal) confidential information (the contents and publication date of the columns). The Court, apparently split on the validity of the misappropriation theory, (at least when applied to the facts of the *Carpenter* case), nevertheless affirmed a mail fraud conviction 8 to 0.

²⁷ 17 C.F.R. § 240.14e-3 (1990). The rule provides in full:

Rule 14e-3. Transactions in Securities on the Basis of Material, Nonpublic Information in the Context of Tender Offers

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of the securities sought or to be sought by such tender offer, or
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securi-

was to avoid the impact of the *Chiarella* ruling that knowing

ties, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

(b) A person other than a natural person shall not violate paragraph (a) of this section if such person shows that:

- (1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) of this section or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and
- (2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a) of this section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(c) Notwithstanding anything in paragraph (a) of this section to the contrary, the following transactions shall not be violations of paragraph (a) of this section;

- (1) Purchase(s) of any security described in paragraph (a) of this section by a broker or by another agent on behalf of an offering person; or
- (2) Sale(s) by any person of any security described in paragraph (a) of this section to the offering person.
 - (d) (1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section except that this paragraph shall not apply to a communication made in good faith,
 - (i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;
 - (ii) To the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or
 - (iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.
 - (2) The persons referred to in paragraph (d)(1) of this section are:
 - (i) The offering person or its officers, directors, partners, employees or advisors;
 - (ii) The issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or

possession is not sufficient to support a conviction under Rule 10b-5. In 1988 Congress gave serious consideration to adopting a possession test but did not do so.²⁸

Following *Chiarella*, the Supreme Court had occasion to further elaborate upon the type of duty that is necessary to trigger the disclosure-or-abstain obligation. The absence of a mere possession test under Rule 10b-5 was further clarified in *Dirks v. Securities and Exchange Commission*.²⁹ In *Dirks* the Court held that a tippee of inside information will not be held accountable unless the tipper was himself or herself acting in violation of a fiduciary duty. *Dirks* involved an enforcement action against an investment advisor who had been informed by an inside whistleblower that Equity Funding Corporation was involved in serious accounting fraud that subsequently led to the company's insolvency. After trying to alert the regulatory authorities, the defendant, *Dirks*, advised his clients to sell Equity Funding stock. The Court held that since information had not been passed on to *Dirks* for the purpose of improper insider trading and further since *Dirks* tried to aid in uncovering the fraud prior to advising his clients, his passing on the information to his clients could not properly be said to be in violation of Rule 10b-5. The Court explained that "a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material non-public information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."³⁰

advisors;

- (iii) Anyone acting on behalf of the persons in paragraph (d)(2)(i) of this section or the issuer or persons in paragraph (d)(2)(ii) of this section; and
- (iv) Any person in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from any of the above.

(emphasis added).

²⁸ See note 75 and accompanying text *infra*.

²⁹ 463 U.S. 646 (1983).

³⁰ *Id.* at 660.

II. THE *Chestman* DECISION

In *United States v. Chestman*³¹ a three judge panel of the Second Circuit was called upon to examine the scope of Rule 10b-5 and the validity of Rule 14e-3. The defendant Robert Chestman, a broker and financial advisor, met with Keith Loeb to discuss Loeb's transfer of various brokerage accounts to Gruntal (Chestman's employer). Loeb had numerous accounts that he wanted to consolidate. Loeb's holdings included stock of Waldbaum, Inc. Loeb's wife, Susan, was the niece of Waldbaum's president and controlling shareholder, Ira Waldbaum, who, along with his immediate family, owned approximately fifty-one percent of the outstanding Waldbaum stock. Ira Waldbaum's sister, Shirley Witkin, owned a large block of the family-held Waldbaum stock; her children, including Susan Loeb, owned less than one percent. During the course of Chestman's relationship with Loeb, Chestman executed a number of transactions involving Waldbaum stock. During the course of these transactions, Chestman learned that Loeb's wife Susan was Ira Waldbaum's niece.³² Loeb claimed that he had told Chestman that he had reliable information that Waldbaum was going to be taken over. Prior to the tender offer's public announcement, Chestman purchased shares for himself and for some of his discretionary accounts. Chestman claimed that he did not speak to Loeb until after the announcement of the tender offer and that all of the Waldbaum purchases had been based upon his own research. As described in Judge Miner's opinion for the three judge panel:

In November 1986, Ira Waldbaum entered into negotiations for the sale of Waldbaum to the Great Atlantic and Pacific Tea Company, Inc. (A&P). A&P and Waldbaum executed a stock purchase agreement on November 21 requiring Ira [Waldbaum], as attorney-in-fact for the Waldbaum family stockholders, to tender a controlling block of Waldbaum shares to A&P in exchange for payment of \$50 per share. Ira told [his sister] Shirley he would tender her shares as part of the sale He cautioned her "that [it was] not to be discussed" and was to remain confidential. She turned the stock over to Ira

³¹ 903 F.2d 75 (2d Cir. 1990), *rev'd in part, aff'd in part*, No. 89 Civ. 1276 (Oct. 7, 1991) (in banc).

³² Some of the trades required that Loeb send Chestman a copy of his wife's birth certificate, which indicated that Susan Loeb was the daughter of Shirley Waldbaum Witkin. *Id.* at 77.

Susan Loeb became concerned when she could not locate her mother at home on the morning of November 24. When she spoke to her mother later that day, her mother revealed that she had gone out to turn the shares over to Ira. Mrs. [Shirley] Witkin told her daughter about the impending sale and stated that "it was very important that [she] didn't tell anybody about it because it could ruin the sale. And that financially it was going to be a beneficial thing." She further told Susan [Loeb] not to tell anyone except her husband. The next day, Susan told her husband about the sale and admonished him not to tell anyone because "it could possibly ruin the sale."

On November 26, Keith Loeb telephoned Chestman at 8:58 a.m. but was unable to contact him. The call from Loeb and the message "asap" was recorded on a message slip. Loeb testified that he spoke to Chestman by telephone from his factory in New Jersey sometime between 9 a.m. and 10:30 a.m., when he left for his office in New York City. Loeb told Chestman that he "had some definite, some accurate information" that Waldbaum was being sold at a "substantially higher" price than the market value of its stock. Loeb "asked [Chestman] what he thought I should do" with the information, but Chestman refused to give him a definite answer.

At 9:49 a.m. Chestman purchased 3000 shares of Waldbaum for himself at \$24.65 per share. Between 11:31 a.m. and 12:35 p.m. Chestman purchased a total of 8000 shares for his discretionary accounts at prices ranging between \$25.75 and \$26.00 per share. Included in these purchases were 1000 shares for the Loeb account. He recorded all the discretionary account trades on his desk blotter but did not write Loeb's name next to the trade for the Loeb account.

Loeb testified that he again contacted Chestman before 4:00 p.m. and ordered the purchase of 1000 shares. Chestman denied having spoken to Loeb before 9:49 a.m. and did not recall an order from Loeb later in the afternoon. Chestman's administrative assistant testified that Loeb called around 9 or 10 a.m., that he called a second time in the "late morning" or "early afternoon," and that, as of the second call, Loeb still had not spoken to Chestman.

The tender offer was announced at the close of trading on November 26, and the price of Waldbaum shares rose to \$49.00 on the next trading day. On the following Saturday, Loeb received the confirmation slip, feigning surprise about the purchase in the presence of his wife.³³

The jury believed Loeb's version of the facts and convicted Chestman of violating SEC Rules 10b-5 and 14e-3. Chestman was also convicted of mail fraud and perjury in connection with his testimony before the SEC. The Second Circuit three judge

³³ *Id.* at 77-78.

panel unanimously reversed the Rule 10b-5, mail fraud,³⁴ and perjury convictions; and by a two-to-one margin reversed the Rule 14e-3 conviction.³⁵

A. *The Rule 10b-5 Claim*

With regard to the Rule 10b-5 count, the three judge panel was unanimous in ruling that Chestman, as a remote tippee, could not be said to have violated the rule. The inapplicability of Rule 10b-5 was based on the absence of anything in the record indicating that the information which Loeb had passed on to Chestman had been given to Loeb in a position of confidentiality.³⁶ The Supreme Court's decisions in *Chiarella* and *Dirks*

³⁴ With respect to the mail fraud charges, following reasoning similar to its analysis of Rule 10b-5, the court held that "[a]fter passing through several family channels, it cannot be said that the information was confidential to any degree or was any more than 'family gossip.'"). *Id.* at 80.

³⁵ *Id.*

³⁶ As explained by the court:

Evidence that Keith Loeb revealed the critical information in breach of a duty of trust and confidence known to Chestman is essential to the imposition of liability upon Chestman as aider/abettor, *Materia*, 745 F.2d at 201, or as tippee, *Dirks*, 463 U.S. at 660. Such evidence is lacking here. Although Chestman was aware that Loeb was a member of the Waldbaum family and may well have gathered that the "definite" and "accurate" information furnished by Loeb was not generally available, there simply is no evidence that he knew that Loeb was breaching a confidential relationship by imparting the information to him. The government can point to nothing in the record demonstrating actual or constructive knowledge on the part of Chestman that Keith Loeb was pledged to secrecy by Susan Loeb, who was pledged to secrecy by Shirley Witkin, who was pledged to secrecy by Ira Waldbaum. Loeb testified on direct examination that he could not recall describing the information as confidential, and there is no evidence that he ever alluded to the source of his information. *Cf. Materia*, 745 F.2d at 202. It is impossible to attribute knowledge of confidentiality to Chestman in view of the attenuated passage of the information and in the absence of any showing that the information retained any kind of confidentiality in the hands of Keith Loeb.

Even assuming knowledge of Loeb's duty of confidentiality on the part of Chestman, there is no demonstration of the acceptance of that duty by Loeb. There is presented here a chain of relationships, each link purportedly representing a pledge of trust and confidence. But there is no showing of any assurance, express or implied, by any of those to whom the information was confided, that confidentiality would be maintained. *See Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 799 (2d Cir. 1980). Without more, such as a course of dealing, a family relationship alone cannot carry an implied promise that confidences of this kind will be maintained. *Compare Reed*, 601 F. Supp. at 706 & n.32.

Id. at 79-80.

made it clear that, without more, a tippee's use of information is not sufficient to violate Rule 10b-5. A Rule 10b-5 violation requires that the defendant be under some duty to disclose or abstain from trading. The Court in *Chiarella* held that knowledge that information is both material and nonpublic is not enough to invoke the disclose-or-abstain rule.³⁷ The Court in *Dirks* held a tippee is not under a duty of disclosure because of the absence of a position of trust and confidence; he or she cannot be held accountable under Rule 10b-5 unless the tip was tainted by the tipper's breach of such a duty.³⁸ *Chiarella* and *Dirks* taken together thus require some basis (other than the possession of information) for invoking the alternative duty to disclose or abstain from trading. This duty may be based either on the trader's having obtained the information by virtue of occupying a position of trust and confidence sufficient to place him or her under a fiduciary duty or, alternatively, that the tipper's breach of such a duty tainted the information in the hands of the tippee trading on the basis of the information. Since neither of these two scenarios could be said to have been the case in *Chestman*, the three judge panel felt compelled to overturn the Rule 10b-5 conviction.

Although affirming the three judge panel's rejection of the Rule 10b-5 claim, the full court was more sharply divided. Six of the judges agreed with the panel while five did not. Judge Meskill's opinion on the 10b-5 issue, in which he was joined by five other judges,³⁹ explained that 10b-5 liability could be based on the misappropriation theory which requires that the defendant have been "in breach of a fiduciary duty or similar relationship of trust and confidence"⁴⁰ After noting that entrusting someone with confidential information does not unilaterally impose a fiduciary duty, the opinion pointed out that *Chestman* and his customer Loeb had been dealing at arm's length. This led to the conclusion that the absence of a preexisting special relationship between them precluded the conclusion that *Chestman* held the information in a fiduciary capacity. The

³⁷ 445 U.S. 222, 235 (1980).

³⁸ *Dirks v. SEC*, 463 U.S. 646, 665 (1983).

³⁹ Judges Cardomone, Pratt, Miner and Altamari joined in the opinion and Judge Mahoney concurred only on the Rule 10b-5 issue. Judge Mahoney dissented from the 14e-3 decision, sticking to the position he took while sitting on the three judge panel.

⁴⁰ *Chestman*, No. 89 Civ. 1276, slip op. at 33 (Meskill, J.).

opinion next went on to examine whether the marriage relationship was itself a special relationship so as to trigger Rule 10b-5's disclose-or-abstain obligation. Relying on both trust law principles and securities law precedent,⁴¹ the court ruled that the family relationship was neither a fiduciary or other special relationship sufficient to invoke Rule 10b-5. The opinion explained that fiduciary relationships are based on trust and confidence arising out of " 'reliance, and de facto control and dominance.' "⁴² A fiduciary relation therefore exists when " 'confidence is reposed on one side and there is resulting superiority and influence on the other.' "⁴³ The court concluded that a family relationship by itself lacks the essential element of a fiduciary relationship, namely "discretionary authority and dependency."⁴⁴ Based on these principles, the majority opinion in *Chestman* found insufficient evidence to support the existence of a fiduciary relationship or functional equivalent between Loeb and the Waldbaum family. Since neither Chestman (the broker) nor Loeb (the customer who passed the information on to him) were fiduciaries nor in a similar position of trust and confidence, the Rule 10b-5 claims could not be upheld.

Five of the eleven judges disagreed with the majority on the 10b-5 count. The opinion by Judge Winter concluded that Chestman's conviction could be upheld either on the misappropriation theory or on the tippee liability rationale embodied in the Supreme Court's decision in *Dirks*.⁴⁵ The dissent was of the view that more than a mere family relationship was involved

⁴¹ *Id.* at 38 (relying on *United States v. Reed*, 601 F. Supp. 685, 705 (S.D.N.Y.) ("the existence of a confidential relationship must be determined independently of a preexisting family relationship"; father and son relationship standing alone was not sufficient), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); G. BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* §482 at 300-11 (rev. 2d ed. 1978) ("mere kinship does not itself establish a confidential relation")).

⁴² No. 89 Civ. 1276, slip op. at 40 (Meskill, J.) (quoting *United States v. Magiotta*, 688 F.2d 108, 125 (2d Cir. 1982), *cert. denied*, 461 U.S. 913 (1983)).

⁴³ *Id.* at 40 (Meskill, J.) (quoting *Mobil Oil Corp. v. Rubenfeld*, 72 Misc. 2d 392, 400, 339 N.Y.S.2d 623, 632 (Civ. Ct. 1972), *aff'd*, 77 Misc. 2d 962, 357 N.Y.S.2d 589 (Sup. Ct. App. T. 1974), *rev'd on other grounds*, 48 A.D.2d 428, 370 N.Y.S.2d 943 (2d Dep't 1975), *aff'd*, 40 N.Y.2d 936, 358 N.E.2d 882, 390 N.Y.S.2d 57 (1976)).

⁴⁴ No. 89 Civ. 1276, slip op. at 41, 45-46.

⁴⁵ *Id.* at 19 (Winter, J., concurring in part and dissenting in part). Judge Winter's opinion was joined by Chief Judge Oakes and Judges Newman, Kearse, and McLaughlin. All five of these judges concurred in the court's reinstatement of the Rule 14e-3 conviction.

since it was dealing with a family-owned corporation. These facts involved not merely a familial relationship but the intertwining of family and business relationships in connection with a family-controlled business. As a result of this mixed business/family relationship, Loeb had sufficient access to inside information so as to justify a concomitant duty not to trade on the information. As Judge Winter explained, the Rule 10b-5 disclose-or-abstain duty should apply to a family member:

(i) who has received or expects (e.g., through inheritance) benefits from family control of a corporation . . . (ii) who is in a position to learn confidential corporate information through ordinary family interactions, and (iii) who knows that under the circumstances both the corporation and the family desire confidentiality . . .⁴⁶

The dissent is quite convincing on this point as *Chestman* involved more than a mere family relationship. While the dissent presents a better interpretation of the proper scope of insider trading regulation, the majority's opinion points out the problem with premising insider trading liability on Rule 10b-5 which was not drafted with this end in mind. Rather than having courts stretch rules to fit the situation, rules should be designed to combat the problem directly. The decision in *Chestman* therefore demonstrates the need for rules and or statutes defining more precisely the scope of what constitutes illegal insider trading. In contrast to Rule 10b-5, Rule 14e-3 is such a rule, although limited in scope to tender offers.

B. *The Rule 14e-3 Claim*

With the 10b-5 issue disposed of, the panel in *Chestman* turned to the Rule 14e-3 conviction. As noted above, unlike section 10(b), section 14(e) and Rule 14e-3 on their face are not limited to fraud (thus requiring an independent basis for a duty to disclose) but rather premise the violation upon knowingly trading while in possession of material nonpublic information about a pending tender offer.

Each of the three judges in *Chestman* took a different ap-

⁴⁶ *Id.* at 21-22 (Winter, J., concurring in part and dissenting in part). In the instant case, Loeb expected stock via gift. The opinion criticized the majority for indicating that something more in the way of a formal contract or business arrangement is necessary to impose a duty on family members and that by doing so the court was treating family members no differently from persons dealing purely at arm's length.

proach to Rule 14e-3. Judge Miner, who wrote the three judge panel's opinion on the Rule 10b-5 issue, would have held that, unlike Rule 10b-5, Rule 14e-3 does not require a breach of a fiduciary duty. According to Judge Miner, Rule 14e-3 requires more than a showing of "mere possession" of information by the defendant.⁴⁷ However, he would have sustained the conviction since the prosecution established "that the trader [knew], or [had] reason to know, that the information [was] material and nonpublic and derive[d] directly or indirectly from an insider."⁴⁸ Judge Mahoney agreed that Rule 14e-3 does not require breach of a fiduciary duty but reasoned that since that requirement is imposed by section 14(e) of the Act, the rule is invalid. He relied in part on the Supreme Court's decision in *Schreiber v. Burlington Northern, Inc.*,⁴⁹ which held that, as is the case with section 10(b) (and therefore Rule 10b-5), section 14(e) can be violated only if the conduct complained of is deceptive. Judge Carman agreed with Judge Mahoney that section 14(e) requires more than Rule 14e-3 on its face would require. Specifically, the deception requirement means that the conduct complained of must be fraudulent.⁵⁰ Judge Carman voted to reverse the Rule 14e-3 conviction because of the trial judge's failure to instruct the jury on the elements of fraud:

The failure to instruct on all the elements of fraudulent nondisclosure, including that the defendant possessed a mental state embracing an intent to deceive, manipulate, or defraud, that is, that the defendant knew he had a duty to disclose and intentionally failed to do so, is

⁴⁷ 903 F.2d at 84.

⁴⁸ *Id.* (emphasis in original).

⁴⁹ 472 U.S. 1 (1985).

⁵⁰ 903 F.2d at 87-88:

As a general matter, fraud requires proof of the elements of scienter. See *Dirks v. SEC*, 463 U.S. 646, 663 n.23 (1983) ("Scienter - 'a mental state embracing intent to deceive, manipulate, or defraud,' *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193-194, n.12 (1976) — is an independent element of a Rule 10b-5 violation."), and breach of duty. *Chiarella*, 445 U.S. at 228. Fraud in the context of a failure to disclose under the securities laws requires a showing that the accused has violated an affirmative duty to speak. *Id.* at 235 ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

See also, e.g., *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985) (deceptive conduct is precondition to a rule 14(e) violation; manipulative has same meaning in 14(e) as it has in 10(b)); *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (deceptive conduct is a precondition for a rule 10b-5) violation.

in my opinion fatal to his conviction.⁵¹

Thus, it was reasoned that the conviction had to be reversed due to the failure to instruct the jury on all the elements of fraud. Following the decision of the three judge panel, Rule 14e-3 could be violated only when defendants use nonpublic information knowing that they are under a duty to disclose or abstain from trading. As such, the ruling of the three judge panel severely limited the availability of Rule 14e-3 to remote tippees.

The correctness of the panel's decision in *Chestman* depends upon the breadth of section 14(e) since, as written, Rule 14e-3 clearly purports to cover the broker's transactions that formed the basis for the conviction. Section 14(e) outlaws material misstatements and omissions as well as deceptive or manipulative acts in connection with a tender offer; the section also contains a grant of rulemaking authority:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request or invitation. *The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.*⁵²

The scope of section 14(e) has been considered by the Supreme Court. In *Schreiber v. Burlington Northern, Inc.*⁵³ a target company's management's renegotiation of the terms of a tender offer was challenged as having been manipulative and therefore in violation of the Act. The Supreme Court ruled that section 14(e) is limited to deceptive conduct and since there was no misrepresentation or actionable nondisclosure in connection with the alleged manipulation, the Act was not violated. In so ruling the Court used its judicial eraser to eliminate the term "manipulative" from the statute.⁵⁴ The Court further made it clear that

⁵¹ 903 F.2d at 88.

⁵² 15 U.S.C. § 78n(e) (1988) (emphasis added).

⁵³ 472 U.S. 1, 7-8 (1985).

⁵⁴ For a fuller discussion of the *Schreiber* decision and its implications, see 1 T. HAZEN, *supra* note 1, § 11.15, at 718-19.

section 14(e) was to be narrowly construed. In the course of its opinion in *Schreiber*, the Court noted that the concept of "manipulative" in section 14(e) is coextensive with the meaning of that term as used in section 10(b).⁵⁵ The Court's reliance on previous holdings under section 10(b) has powerful implications for Rule 14e-3. If the duty to disclose and scienter requirements that apply to insider trading cases under Rule 10b-5 apply equally to section 14(e) and Rule 14e-3,⁵⁶ the panel's ruling is arguably correct. Under such a construction, presumably, Judge Carman's opinion which would read fraud into the rule is a preferable approach to the one taken by Judge Mahoney who would have invalidated the rule.

The Supreme Court has taken a similar approach to Rule 10b-5 which, inter alia, purports to prohibit material misstatements in connection with a purchase or sale of a security.⁵⁷ For a long time, a number of courts held that negligent conduct could form the basis of a Rule 10b-5 violation.⁵⁸ However, in *Ernst & Ernst v. Hochfelder*,⁵⁹ the Court held that although Rule 10b-5 on its face might seem only to require negligence, since the statute speaks only of a "manipulative or deceptive device or contrivance,"⁶⁰ those terms must be read into the rule, thus requiring a showing of scienter. Just as the Court in *Hochfelder* did not invalidate Rule 10b-5(2) and (3) because of the absence of an express limitation in scope to deceptive conduct, Judge Mahoney's wholesale invalidation of Rule 14e-3 is equally inappropriate.

It does not follow from the Rule 10b-5 cases that the reversal of Chestman's conviction was mandated by the statutory language. Judge Miner's position—that Rule 14e-3 does not require a showing of fraud—can be supported by the language of section

⁵⁵ 472 U.S. at 7-8.

⁵⁶ See *Dirks v. SEC*, 463 U.S. 646 (1983); *United States v. Chiarella*, 445 U.S. 222 (1980); notes 23-26 and accompanying text *supra*.

⁵⁷ 17 C.F.R. § 240.10b-5(2) (1990).

⁵⁸ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (holding that a negligently drafted press release containing materially misleading information violated Rule 10b-5). Cf. *Aaron v. SEC*, 446 U.S. 680 (1980) (holding that subsection (2) and (3) of section 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)) can be violated by negligent conduct). See generally 2 T. HAZEN, *supra* note 1, § 13.4.

⁵⁹ 425 U.S. 185 (1976).

⁶⁰ 15 U.S.C. § 78j(b) (1988).

14(e). Section 14(e) empowers the SEC not only to define "fraudulent, deceptive, or manipulative" conduct; it also gives the Commission the power to "prescribe means *reasonably designed to prevent*, such acts and practices"⁶¹ This should be taken to mean that in prescribing such means the Commission can cast a wide net that might catch conduct which itself is not fraudulent, deceptive or manipulative, so long as the Rule is "reasonably designed to prevent" such conduct. As the ruling by the full court in *Chestman* recognized, this language is in contrast to that of section 10(b) of the Act which merely gives the Commission the power to define the scope of deceptive and manipulative conduct but does not contain the additional grant of authority contained in section 14(e).

Congress has been known to cast such a wide net in order to prohibit abusive insider trading. Consider for example, section 16(b) of the Exchange Act which was enacted "[f]or the purpose of preventing unfair use of information which may have been obtained by an insider from his or her company."⁶² In order to effectuate this stated purpose, section 16(b) provides that all profits realized by ten percent beneficial owners, officers, and directors, from purchases and sales (or sales and purchases) within a six-month period may be recovered by the corporation. Section 16(b) requires disgorgement even though there was no actual use of information. Congress believed that this prophylactic section was necessary to prevent abuse.⁶³ The language of section 14(e) should be similarly read to grant the SEC the power to promulgate prophylactic rules so long as they are *reasonably designed* to catch fraudulent, deceptive, or manipulative conduct within the meaning of that section. Rule 14e-3 is just such a rule.

On rehearing, Judge Mahoney remained true to his position in the panel decision and stood alone among the eleven judges in calling for reversal of the Rule 14e-3 conviction.⁶⁴ The majority relied on both the statutory language and legislative history in ruling that Rule 14e-3 does not require a showing of fraud. The court began by pointing out that the last sentence of section

⁶¹ 15 U.S.C. § 78n(e) (1988) (emphasis added).

⁶² 15 U.S.C. § 78p(b) (1988).

⁶³ See generally 2 T. HAZEN, *supra* note 1, § 12.3 & n.3.

⁶⁴ No. 89 Civ. 1279, slip op. at 1 (Mahoney, J., concurring in part and dissenting in part).

14(e) gives the SEC broad prophylactic rule-making authority and that "[t]his delegation of rule-making responsibility becomes a hollow gesture if we cabin the SEC's rulemaking authority . . . by common law definitions of fraud."⁶⁵ The opinion drew support for this conclusion from the fact that the language of section 14(e) does not parallel section 10(b) wherein the fraud requirement is found, but more closely resembles section 15(c)(2)⁶⁶ which governs broker-dealer practices in the over-the-counter markets. Although the Supreme Court in *Schreiber v. Burlington Northern, Inc.* analogized 14(e) to section 10(b) when imposing the deception requirement, that decision also noted the difference between the two sections, in that the last sentence of section 14(e) "gives the [SEC] latitude to regulate *nondeceptive* activities as a 'reasonably designed' means of preventing manipulative acts"⁶⁷ The Second Circuit thus properly concluded that the clear language of section 14(e) does not impose a fraud requirement on Rule 14e-3. The court drew further support for its conclusion from the legislative history of recent insider trading legislation. In the deliberations underlying the enactment of the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988, there is evidence that Congress was aware of the broad reach of the language of Rule 14e-3 and its effect.⁶⁸

In reinstating the Rule 14e-3 conviction, the Second Circuit properly avoided an unduly narrow interpretation of the Supreme Court's decision in *Schreiber*. Section 14(e) was designed to enable the SEC to curb manipulative and deceptive practices in connection with tender offers. Rule 14e-3 as applied in *Chestman* is reasonably designed to prevent such conduct.

III. IMPLICATIONS

One of the purposes in promulgating Rule 14e-3 was to avoid the Rule 10b-5 requirement, as announced in *Chiarella*,

⁶⁵ *Id.* at 13 (Meskill, J., opinion).

⁶⁶ 15 U.S.C. §78o(c)(2) (1988).

⁶⁷ 472 U.S. 1, 11 n.11 (1985) (quoted in No. 89-1279, slip op. at 25 (Meskill, J., opinion)).

⁶⁸ No. 89-1279, slip op. at 17-18 (Meskill, J., opinion) (citing H.R. REP. NO. 355, 98th Cong., 1st Sess. 4, 11, 13 n.20, reprinted in 1984 U.S. CODE CONG. & ADMIN. NEWS 2274, 2277, 2284, 2286 n.20; H.R. REP. NO. 910, 100th Cong., 2nd Sess. 14, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6051).

that there be some basis for a duty to disclose other than the knowing possession of nonpublic information. The decision of the three judge panel in *Chestman* would have eliminated that advantage.

The *Chestman* decision reiterated the holding of the Supreme Court in *Dirks*, that for a remote tippee to be held liable under Rule 10b-5, there must be evidence that he or she traded while knowing that the nonpublic information was in fact confidential. *Chestman* does not, however, change the rule that someone who is not an insider may nevertheless be held liable for trading on confidential information when the trader acts in breach of a fiduciary duty. In *United States v. Willis*⁶⁹ a psychiatrist was indicted under Rule 10b-5 for allegedly trading on information obtained from a patient in the course of treatment. The patient was the spouse of a noted corporate executive who was considering becoming chief executive officer of BankAmerica Corporation. Armed with this information, the psychiatrist purchased BankAmerica stock. The court upheld the indictment since the psychiatrist received the information while in a position of trust and confidence and breached that trust when he acted on that information for his personal benefit. Following the panel decision in *Chestman*, the psychiatrist argued that since he was not directed to keep the information confidential, he could not be said to have violated any duty. The court rejected that argument, reasoning that the information that was passed on to the psychiatrist was confidential by its very nature and thus he was not a remote tippee but rather was the one who breached a position of trust.⁷⁰ Based on the Supreme Court precedent as set forth in *Chiarella* and *Dirks* the existence of a fiduciary or comparable duty is the essence of Rule 10b-5's disclose-or-abstain rule. Within this context, the *Willis* decision

⁶⁹ 737 F. Supp. 269 (S.D.N.Y. 1990).

⁷⁰ *Id.* at 275:

Chestman does not require a holding in this case that it is necessary for a patient to tell her treating psychiatrist that he should not disclose information confided to him by her in the course of her treatment . . . By revealing the information to her psychiatrist in the course of treatment, Mrs. Weill did not breach the duty of trust and confidence which she owed to her husband. According to the allegations of the Indictment, it was only the defendant Willis who breached a duty of trust and confidence by misappropriating valuable nonpublic confidential information acquired by him in the psychiatrist-patient relationship.

makes sense, as does Judge Meskill's decision in *Chestman*. Such results, however, highlight the fact that Rule 10b-5 is an imperfect weapon to combat the pernicious practice of trading on the basis of nonpublic material information. As *Chestman* also shows, Rule 14e-3 may serve as a substitute weapon in some instances.

The *Willis* decision points to the extent to which the securities laws have been stretched. Since there is no statutory definition of what constitutes improper trading on nonpublic information, the courts have been forced to rely on the general antifraud provisions. Since those provisions are based in fraud, there must be some breach of an independent duty. However, as the *Willis* decision points out, the duty need not be one connected to the corporation or to securities. Whatever the purpose of Congress in enacting sections 10(b) and 14(e), it cannot seriously be contended that it was concerned with preserving the integrity of the psychiatrist-patient relationship. Nor, as *Chestman* points out, was Congress addressing the sanctity of marriage and family. Similarly, Congress was not concerned with the sully of investment banking firms' reputations.⁷¹ On the other hand, the activity in the *Willis* case, like that in the *Chestman* case, should be condemned as an interference with the integrity of the market.⁷² Unless and until Congress bites the bullet and defines the scope of improper insider trading, 10b-5 decisions as disparate as *Willis* and *Chestman* will continue to proliferate.

The commentators are divided on the question of whether a

⁷¹ In *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983), Newman, the head of a major brokerage firm's over-the-counter trading department, received a tip from two investment bankers concerning impending takeovers that they were working on. Newman purchased the target company stock in advance of the tender offer announcement and subsequently sold for a profit. The Second Circuit held that Newman conspired with the investment banking firms to misappropriate confidential information from those firms' clients:

By sully the reputations of [the investment bankers] as safe repositories of client confidence, appellee and his cohorts defrauded those employers as surely as if they took their money . . . [the defendant] also wronged [the investment bankers'] clients, whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information.

664 F.2d at 17.

⁷² See, e.g., Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979).

more precise definition is needed.⁷³ In 1987 Congress began to consider legislation that would not only have defined illegal insider trading to encompass the misappropriation theory but also would have contained a remedy for investors in the open market on the other side of the illegal trades. In adopting the 1988 insider trading legislation,⁷⁴ Congress considered adopting a definition of what constitutes improper trading on inside information. There was some movement to expand the misappropriation theory by outlawing trading while in possession of material, non-public information. It was alternatively proposed that a possession test was too broad and the prohibition should be limited to the improper *use* of the information. Nevertheless, as was the case in 1984, the attempt to legislatively define insider trading was dropped and the statute was enacted without any such definition.⁷⁵ However, in the legislative history, there is a clear en-

⁷³ See, e.g., Symposium, *Defining "Insider Trading"*, 39 ALA. L. REV. 337 (1988). See also, e.g., Wolfson, *Trade Secrets and Secret Trading*, 25 SAN DIEGO L. REV. 95 (1988).

⁷⁴ The legislation specifically addressed a number of enforcement issues. Under the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) a court can impose ITSA penalties on a controlling person of a primary violator only if: (1) the controlling person knew or acted in reckless disregard of the fact that the controlled person was likely to engage in illegal insider trading and (2) the controlling person failed to take adequate precautions to prevent the prohibited conduct from taking place. 15 U.S.C. § 78u-1(b)(1)(A). In addition, broker-dealers are specifically directed to establish, maintain, and enforce written policies designed to prevent insider trading violations by their employees. 15 U.S.C. § 78o(f). A similar provision exists for investment advisers. 15 U.S.C. § 80b-4A.

Perhaps the most significant aspect of ITSFEA is its applicability to private enforcement. Section 21A(e) of the Exchange Act now permits the payment of a bounty of up to ten percent of the penalty to private individuals who provide information leading to the imposition of the penalty. 15 U.S.C. § 78u-1(e). ITSFEA also created an express private right of action for contemporaneous traders. Section 20A of the Exchange Act now provides that anyone violating the Act or SEC rules while trading in possession of material, nonpublic information shall be liable to contemporaneous traders trading on the other side of the insider trader's transactions. 15 U.S.C. § 78t-1(a). Thus, if the violator is selling, all contemporaneous purchasers can sue while if the violator is purchasing, all contemporaneous sellers can sue. Damages in such an action are limited to the profits or losses avoided by the illegal transactions and are to be diminished by any disgorgement (as opposed to penalty) ordered in an SEC action under ITSA. *Id.*

⁷⁵ See REPORT OF THE COMM. OF ENERGY AND COMMERCE, H.R. REP. NO. 910, 100th Cong., 2d Sess. 11, reprinted in 1988 U.S. CODE CONG. & ADMIN. NEWS 6048:

While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be

dorsement of the misappropriation theory as recognized by the Second Circuit.⁷⁶ It is to be hoped that Congress will eventually enact legislation containing a definition of illegal insider trading that is based on a "possession" test and thereby finally put these issues to rest.

narrowing, and in an unintended manner facilitate schemes to evade the law. Second, the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation. The legal principles governing insider trading cases are well-established and widely-known.

⁷⁶ *Id.* at 10, reprinted in U.S. CODE CONG. & ADMIN. NEWS at 6047 ("[T]he misappropriation theory clearly remains valid in the Second Circuit . . . but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5."). See Weiss & Spolan, *Preventing Insider Trading*, 19 Rev. Sec. & Comm. Reg. 233 (1987) (urging institutional guidelines and policies).

