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Corporate Law: Will Requiring a Breach of a Fiduciary Duty Under Rule 14e-3 of the Securities Exchange Act Encourage Market Efficiency By Protecting the Flow of Information Into the Market, Or Will It Undermine Investor Confidence in the Market? (United States v. Chestman, 903 F.2d 75 (2d Cir. 1990))

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CORPORATE LAW: WILL REQUIRING A BREACH OF A FIDUCIARY DUTY UNDER RULE 14e-3 OF THE SECURITIES EXCHANGE ACT ENCOURAGE MARKET EFFICIENCY BY PROTECTING THE FREE FLOW OF INFORMATION INTO THE MARKET, OR WILL IT UNDERMINE INVESTOR CONFIDENCE IN THE MARKET

United States v. Chestman, 903 F.2d 75 (2d Cir. 1990)

Appellant was charged with fraudulent trading in connection with a tender offer in violation of Rule 14e-3 of the Securities Exchange Act.[1] Appellant was a stockbroker who traded in the stock of a corporation based on non-public information of a pending tender offer.[2] He was allegedly given the information by a client[3] who was a relative

1. United States v. Chestman, 903 F.2d 75, 77 (2d. Cir. 1990). The appellant was charged with ten counts of securities fraud in violation of 15 U.S.C. §§ 78j(b), 78ff (1988) ("Section 10(b)"), 18 U.S.C. § 2, and 17 C.F.R. § 240.10b-5 (1988) ("Rule 10b-5"); ten counts of fraudulent trading in connection with a tender offer in violation of 15 U.S.C. §§ 78n(e) ("Section 14(e)"), 78ff, 18 U.S.C. § 2, and 17 C.F.R. § 240.14e-3(a) (1989) ("Rule 14e-3"); ten counts of mail fraud in violation of 18 U.S.C. §§ 1341-1342; and one count of perjury in violation of 18 U.S.C. § 1621. *Id.*

Rule 14e-3 provides in pertinent part:

> (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 non-public and which he knows or has reason to know has been acquired directly or indirectly from:
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> (1) The offering person,
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> (2) The issuer of the securities sought . . . by such tender offer, or
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> (3) Any officer, director, partner or employee or any other person acting . . . to purchase or sell or cause to be purchased or sold any of such securities . . . or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

2. *Chestman*, 903 F.2d at 77. The information concerned a confidential agreement between the Great Atlantic and Pacific Tea Company (A&P), the acquiring firm, and the president of Waldbaum, Inc., the target corporation. Under this agreement the president of Waldbaum, Inc. agreed to tender a controlling portion of Waldbaum, Inc. stock to A&P for $50 per share. *Id.*

3. *Id.* The parties disputed whether the client, Keith Loeb, ever spoke with the appellant directly. Loeb claims that he told the appellant about the tender offer and requested that the appellant purchase the stock for Loeb's account. Although there is evidence that Loeb left a message for the appellant, the appellant said he never returned Loeb's call. *Id.* at 78.

of the president of Waldbaum, Inc., the target corporation.[4] The president of Waldbaum divulged the information in confidence to his sister. His sister then told her daughter, the client's wife. The client's wife told him about the pending offer, and he allegedly told the appellant.[5] In the United States District Court for the Southern District of New York, the jury convicted the appellant.[6] He appealed claiming the Securities Exchange Commission (SEC) exceeded its rulemaking authority in enacting Rule 14e-3 by imposing liability for non-disclosure of material non-public information regarding a tender offer absent a breach of fiduciary duty or wrongful taking of information.[7] A three judge panel of the Second Circuit Court of Appeals overturned the conviction[8] and HELD, fraud in the context of a failure to disclose under Rule 14e-3 of the securities laws requires a showing of a violation of an affirmative duty to speak.[9]

A duty to disclose information arises from the common law duty of loyalty owed by an officer, director, or controlling shareholder to the corporation.[10] The rationale behind this duty is that a corporation

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4. *Id.* Loeb was married to the niece of Ira Waldbaum, Waldbaum, Inc.'s president. *Id.* at 77.

5. *Id.* After executing the stock purchase agreement with A&P, Ira Waldbaum told his sister, a holder of a large portion of Waldbaum, Inc.'s stock, that he would tender her shares to A&P if she would deliver them to him. He also told her that the transaction was confidential, and should not be discussed with anyone. Ira's sister then called her daughter, Loeb's wife. Under the premise of getting a ride to the bank to pick up her shares, Ira's sister told Loeb's wife about the impending sale, and that the information was confidential. The next day Loeb's wife told him about the transaction and asked him not to repeat the information. *Id.*

6. *Id.* at 76. The appellant was convicted by a jury in the United States District Court for the Southern District of New York of securities fraud, fraudulent trading in connection with a tender offer, mail fraud and perjury. *Id.*

7. *Id.* at 77. The appellant also appealed the § 10(b) and Rule 10b-5 securities fraud convictions, the mail fraud conviction, and the perjury conviction. *Id.* at 76.

8. *Id.* at 84. Two of the three judges concurred in the decision to reverse the conviction and one judge dissented. *Id.* at 84, 86. All three judges differed in their reasoning, and each filed a separate opinion. *Id.* at 82, 84, 86. The court also reversed the § 10(b), Rule 10b-5, § 14(e), mail fraud, and perjury counts. *Id.* at 76.

9. *Id.* at 88. Judge Mahoney stated that because Rule 14e-3 does not require a breach of a fiduciary duty, the Securities Exchange Commission exceeded its statutorily granted authority in adopting it. *Id.* at 84. Judge Carman held that although the Securities Exchange Commission did not exceed its authority in adopting Rule 14e-3, the trial court erred in not interpreting Rule 14e-3 using the standards of Rule 10b-5, which thereby require a showing of a breach of a fiduciary duty. *Id.* at 87. The one dissenting judge, Judge Minor, held that Rule 14e-3 was a valid use of the SEC's power. Judge Minor based his opinion on the Supreme Court's statement that Rule 14e-3 requires disclosure "more explicitly addressed to the tender offer context than required by § 10(b)." *Id.* at 83.

10. *See* Note, *Outsider Trading — Morality and the Law of Securities Fraud*, 77 GEO. L.J. 182 (1988); John C. Coffee, Jr., *Outsider Trading, That New Crime*, WALL ST. J., Nov. 14, 1990, at 16A, col. 4; Diamond v. Oreamuno, 248 N.E.2d 910, 912 (N.Y. 1969).

has a property right in the information it develops,[11] and any use of material non-public information by such insiders for their own benefit is essentially stealing.[12] Section 10(b)[13] of the Securities Exchange Act of 1934[14] reinforced this common law doctrine and gave the SEC broad powers to assure fairness and integrity in the stock market[15] under a system of full disclosure[16] that prohibits deceptive and manipulative practices[17] in connection with insider trading,[18] broker-dealer activities,[19] market manipulation activities,[20] mismanagement[21] and tender offers.[22]

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11. Coffee, *supra* note 10; *Diamond*, 248 N.E.2d at 912.

12. Coffee, *supra* note 10; *Diamond*, 248 N.E.2d at 912; Note, *supra* note 10; *see also* Arthur J. Marinelli, *Liability for Insider Trading: Expansion of Liability in Rule 10b-5 Cases*, 22 AKRON L. REV. 45, 47 (1988) (noting that the "misappropriation" theory of insider trading liability makes it a violation of the federal securities laws to trade in securities based on non-public information obtained by a person who is, by a position of trust, under a duty not to use such information for his own gain).

13. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.

14. 15 U.S.C. § 78j(b).

15. Marinelli, *supra* note 12, at 45; Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976); Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5. With the enactment of the Securities and Exchange Act of 1934 and § 10(b), Congress intended to prevent all deceptive and manipulative practices, including those that would develop in future years. *Ernst*, 425 U.S. at 202-03.

16. Securities & Exch. Comm'n v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963). Rule 10b-5 is a broad anti-fraud provision of the federal securities laws: it prohibits fraud, misrepresentation, half-truths, concealment of after-acquired information, and omissions. Securities & Exch. Comm'n v. National Bankers Life Ins., 324 F. Supp 189, 195 (N.D. Tex.), *aff'd*, 448 F.2d 652 (5th Cir. 1971).

17. *See generally* Piper v. Chris Craft Indus., 430 U.S. 1, 45 (1977) (§ 10(b) is focused upon "maintaining an orderly market for the distribution of securities free from artificial or manipulative devices").

18. *See* Note, *Insiders' Liability Under Rule 10b-5 for the Illegal Purchase of Actively Traded Securities*, 78 YALE L.J. 864 (1969).

19. *See* Arnold S. Jacobs, *The Impact of Securities Exchange Act Rule 10b-5 on Broker-Dealers*, 57 CORNELL L. REV. 869 (1972).

20. *See* Green v. Jonhop, 358 F. Supp 413 (D. Or. 1973).

21. *See* Arnold S. Jacobs, *The Role of SEC Rule 10b-5 in the Regulation of Mismanagement*, 59 CORNELL L. REV. 27 (1973).

22. *See generally* Piper v. Chris Craft Indus., 430 U.S. 1, 22-24 (1977) (§ 14(e) was adopted "in response to the growing use of cash tender offers as a means of achieving corporate takeovers").

Courts have had few problems applying Section 10(b) to corporate insiders who trade on the basis of material non-public information in breach of a fiduciary duty to the shareholders of the corporation.[23] But most courts have found it more difficult to convict those individuals outside the corporate structure who are less likely to owe a fiduciary duty to the shareholders but nevertheless can also greatly affect the securities marketplace.[24] Consequently, the relationship between a breach of fiduciary duty and the company whose stock is traded has become more attenuated as courts have extended the fiduciary duty to apply to certain outsiders.[25] The United States Second Circuit Court of Appeals tried to expand the scope of section 10(b) to include outsiders in the landmark case *Securities & Exchange Commission v. Texas Gulf Sulphur Co.*[26]

In *Texas Gulf Sulphur*, the employees of Texas Gulf Sulphur,[27] a mining company, bought stock in the company prior to the public disclosure of a substantial mineral discovery by the company.[28] The SEC brought an action under Rule 10b-5 against the employees.[29] The trial court convicted some of the employees and dismissed the complaint against others.[30] On appeal, the Second Circuit held that all of the involved employees should have been convicted,[31] and took a broad approach to the interpretation of Rule 10b-5,[32] basing its decision on notions of fairness and equity.[33] The court applied what is now known as the equal access, or parity of information, theory.[34] Under this theory the court held that anyone in possession of material inside information, irrespective of any fiduciary duty, must either disclose it to the investing public or abstain from trading in or recommending

23. Dirks v. Securities & Exch. Comm'n, 463 U.S. 646, 653 (1983).

24. Marinelli, *supra* note 12, at 48. *See generally* Dirks v. Securities & Exch. Comm'n, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980).

25. Note, *supra* note 10, at 186.

26. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

27. *Id.* at 839.

28. *Id.* at 841.

29. *Id.* at 839.

30. *Id.* at 842.

31. *Id.* at 864.

32. *Id.* at 848.

33. Richard M. Phillips & Larry R. Lavoie, *The SEC's Proposed Insider Trading Legislation: Insider Trading Controls, Corporate Secrecy, and Full Disclosure*, 39 ALA. L. REV. 439, 447 (1988). *See* Securities & Exch. Comm'n v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

34. Note, *supra* note 10, at 186.

the securities concerned while such information remains undisclosed.[35] The court reasoned that all investors are entitled to the same information when making investment decisions.[36]

However, the Supreme Court did not follow the Second Circuit's broad interpretation of Rule 10b-5,[37] and in *Chiarella v. United States* the Court departed from the parity of information theory.[38] In *Chiarella,* an employee of a financial printer bought stock in companies that were targets of takeover bids based on confidential information he received in the course of his employment.[39] The trial court convicted the employee of violating section 10(b) based on his failure to disclose the information prior to trading,[40] and the Second Circuit Court of Appeals affirmed.[41] The Supreme Court reversed,[42] and rejected the parity of information theory of *Texas Gulf Sulphur.*[43] The Court reasoned that a duty to speak arises not from one's mere possession of, or ability to acquire access to, information, but rather from a fiduciary or similar relationship of trust and confidence between parties to a transaction.[44] The Court therefore held that the printing company employee, an outsider to the affected corporations, could not be liable for a failure to disclose the information because no duty to disclose based on a fiduciary or other confidential relationship existed.[45]

In the dissenting opinion of *Chiarella,* Chief Justice Burger read section 10(b) and Rule 10b-5 to mean that anyone who misappropriates non-pubic information has an absolute duty to either disclose that information or to refrain from trading.[46] Burger sought to apply the disclose or abstain rule whenever an informational advantage is obtained by some unlawful means,[47] as was alleged in *Chiarella.*[48] This

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35. *Texas Gulf Sulphur,* 401 F.2d at 848, 849.
36. *Id.* at 849.
37. Chiarella v. United States, 445 U.S. 222, 223 (1980).
38. *Id.* at 230.
39. *Id.* at 224.
40. *Id.* at 225.
41. *Id.*
42. *Id.* at 237.
43. Note, *supra* note 10, at 187. *See Chiarella,* 445 U.S. at 222, 235 (1980).
44. *Chiarella,* 445 U.S. at 235. The court stated, "[w]e know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal circumstances that might raise a seller's demands and thus abort the sale." *Id.* at 232 n.14.
45. *Id.* at 233.
46. *Id.* at 240.
47. *Id.*
48. *Id.* at 224.

theory of misappropriation closely follows the common law concept of stealing information that belongs to the company,[49] but it holds outsiders liable when information is misappropriated from someone who owes a fiduciary duty to the company.[50] Although the majority in *Chiarella* never reached the claim that Chiarella's misappropriation of information from his employer sufficed for Rule 10b-5 liability,[51] the Second Circuit later accepted Burger's theory of misappropriation.[52] The government and lower courts have since utilized the misappropriation theory to extend the scope of section 10(b) and circumvent the fiduciary duty rule established by *Chiarella*.[53]

In response to the Supreme Court's decision in *Chiarella*, the SEC enacted rule 14e-3[54] under the authority of section 14(e) of the Securities Exchange Act.[55] Section 14(e) makes it unlawful for any person

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49. *See supra* notes 10-12 and accompanying text.

50. *See* United States v. Reed, 601 F. Supp 685, 700 (1985). Under this theory the defendant is not held liable for a breach of a duty to the investors with whom he trades, or with the public at large, but for a breach of duty to the person or legal entity that entrusted him with the information. *Id.* Typically, misappropriation cases involve an employee's breach of a fiduciary duty to an employer who owes a fiduciary duty to an insider. Dirks v. Securities & Exch. Comm'n, 463 U.S. 646, 665 (1983).

51. *Chiarella*, 445 U.S. at 236-37. *See also* Marinelli, *supra* note 12, at 50 (stating that the majority in *Chiarella* did not address the misappropriation theory because it was not part of the instructions given to the jury by the trial court).

52. *See generally* Securities & Exch. Comm'n v. Materia, 745 F.2d 197, 197-203 (2d Cir. 1983). The facts of *Materia* are substantially similar to those of *Chiarella*. In *Materia*, the defendant was an employee of a printing company. The company had an express policy against employees trading on confidential information discovered in the course of their employment. Materia used information he received in the course of his employment to buy stock in target corporations before the information was made public. The Second Circuit Court of Appeals held that Materia violated Rule 10(b) by breaching a duty owed to his employer. *Id. See also* United States v. Newman, 664 F.2d 12 (2d Cir. 1981). Newman was a securities trader who gained advance information on takeover bids from two employees of investment banking firms. Newman passed the information on to others who then traded on it. He was charged with violating Rule 10(b). The Second Circuit Court of Appeals convicted Newman and imputed to the employee the employer's duty to the client; United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 108 S. Ct. 316 (1987); Marinelli, *supra* note 12, at 55.

53. Marinelli, *supra* note 12, at 52. *Chiarella* and *Dirks* limited liability by requiring that a person trading on the basis of inside information breach a fiduciary duty owed either directly or derivatively to the corporation. The duty owed derivatively may arise from being a tippee of an insider who breached his fiduciary duty, or by being a temporary insider by virtue of access to certain confidential information to be used for corporate purposes. *Id.*

54. Harry Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: "Fairness" versus Economic Theory, 37 BUS. LAW. 517, 520 (1982); 17 C.F.R. § 240.14e-3(a). *See supra* note 1 for text of Rule 14e-3.

55. 15 U.S.C. § 78n(e). The section was amended in 1970 to provide that "[t]he 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." *Id.*

to engage in any fraudulent, deceptive, or manipulative acts or practices in connection with a tender offer.[56] In the context of a tender offer, Rule 14e-3 correspondingly imposes upon any person in possession of material, non-public information obtained from an insider, a duty to disclose or abstain from trading.[57]

Rule 14e-3, a broad anti-fraud provision[58] modeled after SEC Rule 10b-5,[59] seeks to insure that shareholders confronted with a tender offer have adequate and accurate information on which to base the decision whether or not to tender their shares.[60] Although there is some authority to the contrary,[61] courts have held, as in *United States v. Marcus Schloss & Co.*,[62] that Rule 14e-3 requires disclosure of material non-public information in the absence of a fiduciary duty, thus treating insiders and outsiders equally.[63]

In *Marcus Schloss*, the defendants were charged with violating Rule 14e-3[64] for trading on the basis of material, non-public information, acquired through a series of "tips" from several individuals.[65]

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56. *Id.*

57. 17 C.F.R. § 240.14e-3(a). Under the authority of the 1970 amendment, the SEC in 1980 adopted Rule 14e-3, which defined as "a fraudulent, deceptive or manipulative act" the purchase or sale of a security by one "who is in possession of material information relating to [a] tender offer which the information he knows or has reason to know has been acquired directly or indirectly" from the issuer, an officer, or any person acting on the issuer's behalf. *Id.*

58. Piper v. Chris Craft Indus., 430 U.S. 1, 24 (1977). The Williams Act, which added Section 14(e) to the securities law, was adopted for the protection of investors who are confronted with a tender offer. *Id.*

59. Schreiber v. Burlington Northern, 472 U.S. 1, 10 (1985); Mark J. Loewenstein, *Section 14(e) of the Williams Act and the Rule 10b-5 Comparisons*, 71 GEO. L.J. 1311, 1312 (1983).

60. *Schreiber*, 472 U.S. at 11; *Piper*, 430 U.S. at 35; Burlington Indus. v. Edelman, 666 F. Supp. 799, 810 (M.D.N.C. 1987).

61. *Edelman*, 666 F. Supp. at 813. The literal wording of Rule 14e-3 doesn't require a fiduciary breach, or a wrongful taking of information. However, the courts have interpreted Section 14(e) as requiring a breach of duty because it is modeled after Rule 10b-5. Thus, the two sections and corresponding rules should be treated analogously. For example, in *Edelman*, the target of a tender offer brought an action to enjoin the offer, claiming that the offeror violated Rule 14e-3. The United States District Court for the Middle District of North Carolina borrowed from cases interpreting Rule 10b-5 and held that a plaintiff must prove the following elements to demonstrate a violation of Rule 14e-3: (1) standing; (2) breach of duty; (3) materiality; (4) scienter; and (5) injury. *Id. See also* Warren v. Reserve Fund, 728 F.2d 741, 744 (5th Cir. 1984); Securities & Exch. Comm'n v. Tome, 638 F. Supp. 596, 620 (S.D.N.Y. 1986).

62. 710 F. Supp. 944 (S.D.N.Y. 1989).

63. *Id.* at 955. The *Marcus Schloss* court cited to the lower court opinion in *Chestman*, 704 F. Supp. 451 (S.D.N.Y. 1989), and agreed with Judge Walker's opinion upholding the validity of Rule 14e-3 without requiring a breach of a fiduciary duty. *Id.*

64. *Marcus Schloss*, 710 F. Supp. at 946. The defendant was also charged with a violation of § 10(b), and conspiracy to obstruct an SEC investigation. *Id.*

65. *Id.* at 948.

The defendants moved to dismiss the complaint,[66] but the United States District Court for the Southern District of New York denied the motion and rejected the defendants' argument that the SEC exceeded its rulemaking authority in adopting Rule 14e-3 by imposing liability in the absence of a fiduciary breach or a wrongful taking of information.[67] The court explicitly stated that a fiduciary duty or a confidential relationship is not required for liability under Rule 14e-3.[68] Although the Supreme Court had previously noted that section 14(e) was modeled after section 10(b),[69] the district court emphasized that section 14(e) requires disclosure "more explicitly addressed to the tender offer context" than that required by section 10(b).[70] Rule 14e-3 was adopted under the authority of section 14(e),[71] a broad congressional mandate to prescribe all "means reasonably designed" to prevent manipulative acts,[72] including regulation of non-deceptive activities.[73] The district court held that the congressional emphasis on disclosure in the tender offer setting permits such regulation.[74] The rulemaking power under section 14(e) is distinguishable from the rulemaking power under section 10(b),[75] allowing liability without a showing of a fiduciary breach or wrongful taking of information.[76]

In the instant case, the Second Circuit departed from the rule of *Marcus Schloss* and held that the appellant could not be convicted of a failure to disclose under Rule 14e-3 absent a showing of a violation of an affirmative duty to speak.[77] Although the majority supported the reversal of the conviction,[78] each judge differed as to the reasoning and therefore each of the three judges filed a separate opinion.[79] In the first opinion for the majority, Judge Mahoney concluded that the SEC exceeded its authority by adopting Rule 14e-3 without requiring a breach of a fiduciary duty.[80] Judge Mahoney centered his reasoning

66. *Id.*
67. *Id.* at 955.
68. *Id.* at 957.
69. *Id.* at 956 (citing Schreiber v. Burlington Northern, 472 U.S. 1, 11 (1985).
70. *Id.* at 957.
71. *Id.* at 956.
72. *Id.* at 957.
73. *Id. See* 17 C.F.R. § 240.14e-3(a).
74. *Marcus Schloss*, 710 F. Supp. at 957.
75. *Id.*
76. *Id.*
77. *Chestman*, 903 F.2d at 88.
78. *Id.* at 86.
79. *Id.*
80. *Id.* at 84.

on the fact that the principles developed under Rule 10b-5 are generally applicable in determining whether violations of section 14(e) have been committed.[81] He also found it important that the SEC adopted Rule 14e-3 in the immediate aftermath of the Supreme Court's ruling in *Chiarella* where a breach of fiduciary duty was found to be essential to establish a violation under section 10(b).[82] Because the Supreme Court rejected the SEC's effort to extend section 10(b) in *Chiarella*, Judge Mahoney reasoned that such an extension of Rule 14e-3 was not within the SEC's rulemaking power.[83] Therefore, Judge Mahoney concluded that Chestman's conviction under Rule 14e-3 could not be upheld.[84]

In the second opinion for the court, Judge Carman agreed that Rule 14e-3 could not be violated without a showing of breach of a fiduciary duty. Judge Carman, however, held that Rule 14e-3 did not constitute an improper use of SEC's rulemaking power.[85] Instead, he concluded that the district court merely interpreted the rule incorrectly.[86] Judge Carman reasoned that because the SEC adopted Rule 14e-3 shortly after *Chiarella*, the SEC presumably wanted Rule 14e-3 to include the commonly accepted principles of fraud, which requires a breach of fiduciary duty.[87] Although Judge Carman stated that Rule 14e-3 constituted a valid use of the power given to the SEC by Congress, he held that because the district court failed to instruct the jury on all the elements of fraud, Chestman's conviction must be reversed.[88]

Only Judge Minor voted to uphold Chestman's conviction.[89] According to Judge Minor, the SEC adopted Rule 14e-3 under the authority of section 14(e), a broad congressional mandate to prescribe all "means reasonably designed" to prevent manipulative acts, including the regulation of non-deceptive activities.[90] Judge Minor held that the congressional emphasis on disclosure in the tender offer context permits such regulation and distinguishes the rulemaking power under section 14(e)

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81. *Id.* at 85. *See* Connecticut Nat'l Bank v. Flour, 808 F.2d 957, 961 (2d Cir. 1987).
82. *Chestman*, 903 F.2d at 85.
83. *Id.* at 86.
84. *Id.*
85. *Id.*
86. *Id.* at 87.
87. *Id.*
88. *Id.* at 88.
89. *Id.* at 84.
90. *Id.* at 82.

from that under section 10(b) and allows liability without a showing of a fiduciary breach or wrongful taking of information.[91] Judge Minor therefore stated that Rule 14e-3 does not require a fiduciary duty or a confidential relationship,[92] and that Rule 14e-3 coincides with the congressional goal of protecting investors in the tender offer context. Thus, Judge Minor concluded that the SEC did not exceed its rulemaking authority in promulgating Rule 14e-3 under the Security Exchange Act.[93]

Two competing rationales for the prohibition of insider trading divided the judges deciding the instant case.[94] First, the property right theory which was supported by the majority decision in the instant case,[95] comes from the common law[96] and was reinforced in *Chiarella.*[97] The property right theory requires a breach of a fiduciary duty for a violation of Rule 14e-3,[98] and states that a corporation has a property right in the confidential business information that it develops. Therefore, an officer misappropriating the corporation's information for his own use is stealing a corporate asset.[99]

The second theory, urged in *Texas Gulf Sulphur*[100] and supported by the dissent in the instant case,[101] is based on broader notions of fairness and equity. This second theory holds that all who trade in the securities market are entitled to parity of information.[102] Under this theory it is wrongful for anyone to trade on material, non-public information, irrespective of any fiduciary duty.[103] Thus, while the property right theory reaches only corporate insiders and those in conspiracy with them,[104] the parity of information theory covers outsiders as well as those whose profession is to search for undiscovered information about corporate securities.[105]

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91. *Id.* at 83.
92. *Id.* at 84.
93. *Id.* at 83.
94. Coffee, *supra* note 10.
95. *Chestman,* 903 F.2d at 85.
96. Coffee, *supra* note 10.
97. Chiarella v. United States, 445 U.S. 222, 240 (1980).
98. *Chestman,* 903 F.2d at 85.
99. *Chiarella,* 445 U.S. at 240.
100. Securities & Exch. Comm'n v. Texas Gulf Sulphur, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).
101. *Chestman,* 903 F.2d at 83.
102. *Id.*
103. *Id.*
104. Note, *supra* note 10, at 182-83.
105. *See* Dirks v. Securities & Exch. Comm'n, 463 U.S. 646, 658 (1983).

Ever since the Supreme Court rejected the parity of information theory in *Chiarella*, the lower courts have tried to inch back to a "fairer" rule that would protect investors' expectations and hold some outsiders liable for insider trading.[106] However, in the instant case, the Second Circuit failed to follow the trend toward holding outsiders liable by refusing to entirely eliminate the fiduciary duty requirement.[107] Instead the Second Circuit reversed the trend by opting for the property right theory and requiring a breach of a fiduciary duty.[108]

The instant court's interpretation of Rule 14e-3 protects investors' and analysts' legitimate investigations for information in the tender offer context.[109] While insiders are rightly restricted from trading on information that belongs to the company, the efficiency of the securities market depends on vigorous competition among securities analysts and other outsiders to find out public information.[110] Securities analysts and other professionals who buy and sell securities constantly receive a flow of market information and usually seek to confirm this information with their sources in corporate management.[111] While outsiders should not be permitted to bribe insiders, steal information, or obtain information through other illegal means, all investors benefit from the outsiders' search for new information.[112] The availability of reliable information leads to better economic decisions, and better economic decisions lead to the most productive allocation of economic resources.[113]

In the case of securities, price serves as the most efficient means of conveying information to the public.[114] The Supreme Court has recognized that in the modern securities market where shares change hands through agents, rather than in face-to-face transactions, investors tend to rely more on the price of the security as opposed to other available information when assessing the value of a security.[115] The

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106. *See generally* Note, *supra* note 10, at 181.
107. *See Chestman*, 903 F.2d at 85.
108. *Id.*
109. Heller, *supra* note 54, at 517 n.4.
110. Coffee, *supra* note 10.
111. Coffee, *supra* note 10.
112. Note, *supra* note 10, at 191.
113. Note, *supra* note 10, at 187 n.39.
114. Heller, *supra* note 54, at 517 n.4. *See* Securities & Exch. Comm'n v. Materia, 745 F.2d 197, 199 (2d Cir. 1983). "Because even a hint of an upcoming tender offer may send the price of the target company's stock soaring, information regarding the identity of a target is extremely sensitive and zealously guarded." *Id.*
115. Note, *supra* note 10, at 187 n.39 (1988); Marinelli, *supra* note 12, at 58.

free exchange of information in the market thus performs a substantial part of the valuation process.[116] If all information is available to the market, the value of the stock is equal to its market price.[117] Allowing outsiders to trade on the basis of information that was not obtained illegally or in breach of a fiduciary duty, helps stock prices to quickly reflect that information and move toward "true" values.[118] Information moving quickly into the marketplace thus creates a more efficient system,[119] because accurate prices, based on a free flow of information, will lead to the optimum allocation of capital.[120]

Had the instant court followed Judge Minor's dissent and adopted a parity of information approach, the court would have advocated holding Chestman guilty of a crime for the mere possession of material, non-public information without proving fraud, thereby treating insiders and outsiders alike.[121] If this were the outcome, the instant case would have had an inhibiting influence on the role of securities analysts in the market.[122] The business of searching for new information would have become dangerously entangled with the criminal law,[123] possibly leading to a slower, less accurate market.[124] Courts in the pursuit of "fairness" and "protection of investors" too often ignore the economic ramifications of their ruling.[125] The public interest undoubtedly favors the efficient functioning of the economy, and therefore is best served by regulation that takes into account both economic and equitable considerations.[126] The minority opinion, however, reflects the belief that an inherent unfairness exists when a party, whether an insider or outsider, takes advantage of information knowing it is unavailable to those with whom he is dealing.[127] Those who have access to material, non-public information, through legal means, without breaching a

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116. Heller, *supra* note 54, at 521; Marinelli, *supra* note 12, at 58.
117. Basic v. Levinson, 108 S. Ct. 978, 990 (1988).
118. Note, *supra* note 10, at 199; Marinelli, *supra* note 12, at 46.
119. Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN L. REV. 857, 866-72 (1983); Note, *supra* note 10, at 187.
120. Note, *supra* note 10, at 199.
121. Marinelli, *supra* note 12, at 49. *See generally Chestman*, 903 F.2d at 84 (Minor, J., dissenting).
122. Note, *supra* note 10, at 199.
123. Coffee, *supra* note 10; Note, *supra* note 10, at 187.
124. Coffee, *supra* note 10.
125. Heller, *supra* note 54, at 517 n.4.
126. *Id.*
127. *See generally Chestman*, 903 F.2d 75.

fiduciary duty, benefit at the expense of the average investor who does not have access to such information.[128]

The great majority of scholars agree that the need to safeguard the confidence, integrity and fairness of the marketplace, to protect investors, and to encourage investment in the securities markets, justifies the prohibition against trading on material, non-public information.[129] The SEC has made countless efforts to attain equality in the availability of material information for all investors.[130] As stated in *Texas Gulf Sulphur*, Rule 10(b) is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.[131] Investors need to rely on the integrity of the market's pricing mechanism to establish securities prices.[132] If investors are not given adequate protection they will perceive that the odds are stacked against them because they do not have access to non-public information.[133] As a result, fewer members of the general public will invest in securities, thereby limiting a means of generating income for both the general public and for corporations who rely on securities as a source of capital.[134]

The court opinions interpreting both Rule 10b-5 and Rule 14e-3 have wavered between holding only insiders liable for non-disclosure of material non-public information, and attempting to hold some outsiders liable as well, thus creating confusion in the securities regulation field. The courts want to encourage market efficiency by protecting the free flow of information into the marketplace, but at the same time try to protect members of the investing public by providing somewhat equal access to information. The courts seem to have found that hinging liability on a breach of a fiduciary duty, as did the Second Circuit Court of Appeals in the instant case, protects the free flow of

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128. Marinelli, *supra* note 12, at 46. *See In Re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961); Note, *supra* note 10, at 191.

129. *See, e.g.*, Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 355-56 (1979); William K.S. Wang, *Trading on Material Non-public Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1248, 1321 (1981).

130. Heller, *supra* note 54, at 517.

131. Note, *supra* note 10, at 200. *See* Securities & Exch. Comm'n v. Texas Gulf Sulphur, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

132. Marinelli, *supra* note 12, at 60; Note, *supra* note 10, at 203.

133. WILLIAM H. PAINTER, THE FEDERAL SECURITIES CODE AND CORPORATE DISCLOSURE 350-51 (1979); Note, *supra* note 10, at 210.

134. Note, *supra* note 10, at 200.

information into the market, but does not provide sufficient protection to the investing public. Consequently, most recent opinions have chipped away at the fiduciary duty requirement in an effort to provide more protection for the investing public. In order to strike a more equitable balance between the two concepts, the courts should require the government to prove willful misconduct. It should be enough that the defendant was aware of his actions and that the acts were deliberately and intentionally done, rather than the result of an innocent mistake, negligence or inadvertence. Thus the courts should abandon the outdated theory of liability that relies on a breach of fiduciary duty and instead seek to limit outsider trading, not out of a concern for injury to the company, but out of concern for the intrinsic nature of the conduct and its effects on the market and other investors.

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