CHOICES: PAVING THE ROAD TOWARD A “DEFINITION” OF INSIDER TRADING

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The regulation of insider trading activity is in trouble. My concern is not that the Supreme Court was cryptic and anticlimactic in its disposition of the misappropriation theory in Carpenter v. United States. Rather, my concern is the way in which various Securities and Exchange Commission (“SEC”) enforcement strategies have contributed to doubtful reasoning of the Supreme Court that has resulted in a regulatory framework for insider trading lacking the coherence necessary for effective enforcement practices. This Article does not focus upon what abuses should be the subject of insider trading regulation—those have been dealt with elsewhere by the author. My immediate mission is to undertake a retrospective view of the way in which poor litigation choices and weak analysis have brought events to the point where it is imperative that Congress define insider trading.

I. RECONSIDERING WINANS’S PROSECUTION

In Carpenter, Winans and his accomplices were prosecuted under rule 10b-5, the antifraud rule of the Securities Exchange Act of 1934, for the “misappropriation” of their advance knowledge of the content of the Wall Street Journal’s “Heard on the Street” column, which Winans coauthored. The use of the misappropriation theory in Winans’s prosecution raises an obvious and

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1. 108 S. Ct. 316 (1987), aff’d on securities fraud counts by an equally divided Court 791 F.2d 1024 (2d Cir. 1986). The Court was equally divided on the issue of the propriety of the defendants’ convictions under the misappropriation theory and therefore affirmed their convictions on this ground without comment.
troubling discontinuity between the theory's emphasis upon "unfairness" in employment relationships and the well-recognized purposes of the antifraud provision: to facilitate informed investment decisions, to protect capital markets from manipulation of stock prices, and generally to sustain investors' confidence in our securities markets. This discontinuity alone should be cause enough to question the misappropriation theory's legitimacy, absent express congressional approval. Certainly, if we blindly assert that rationales such as the misappropriation theory are justified simply because investor confidence is shaken by the prevalent reports of various professionals' abusing their positions of trust by trading on the secrets of their employers' clients, we also may be tempted to proscribe, under the antifraud provision, the employment of overcompensated, inexperienced brokers, many still in their twenties, whose lack of seasoning in bear markets is believed in some quarters to have driven stocks to unreasonably high prices and hastened the market's recent dramatic correction. Of course, regulation based on such a reason would clearly be extreme; it nevertheless dramatizes my concern that one must be very careful to identify the public interest served when insider trading regulation appears driven by no more than a highly impressionistic belief that certain conduct erodes the integrity of capital markets. Unfortunately, such rationales have indeed been the justification for insider trading regulation.

Yet, a far greater concern of mine regarding the misappropriation theory is that it shifts the emphasis from the public arena to a purely private setting. Carpenter illustrates my point. The de-

5. I have previously questioned whether allocational efficiency would in fact be interdicted even if it is assumed that insider trading causes investor malaise that is manifested by investors' discounting security prices as protection against possible harm caused by such trading. See Cox, supra note 2, at 635-42.
fendants in Carpenter raised an important anomaly before the Second Circuit: they were criminally responsible under the federal securities laws for the same type of trading activity that their employer, Dow Jones & Company (the owner of the Wall Street Journal), could lawfully undertake. In a highly privatized view of the question before it, the Second Circuit reasoned that no self-respecting publisher would so trade, and even if the publisher itself chose to trade in this manner, its employees should not be able to do so and destroy the reputation of their employer. A troubling corollary to the Second Circuit’s holding is that it appears to authorize the unthinkable: namely, that Dow Jones & Company lawfully could have licensed Winans to draw a portion of his compensation from its treasury and the remainder of his compensation from an unsuspecting market.

The Second Circuit’s disposition of Carpenter breeds two related and significant concerns: a function of the federal securities law is to protect private employer expectations, and publishers themselves may be free to trade on advance knowledge of the contents of articles they publish. Both of these propositions are unacceptable and, in fact, could have been avoided by the use of litigation strategies more directly focused on Winans’s true securities law violations.

Prosecution for scalping, rather than misappropriation, is one such strategy. The misconduct of Winans was not merely his trading. The locus of his misdeed instead lies in his failure to disclose in his column the purchases or sales he and others had made on the prepublication knowledge of his column’s contents. Winans’s omission impugns his column. His activities were very much like the activities of a broker (or investment adviser) who fails to disclose in connection with his recommendation to a client to purchase a company’s stock that he, the broker, has already purchased the same company’s stock. Like the broker’s clients, those persons reading Winans’s column would have benefitted from the contemporaneous knowledge of Winans’s trading agenda vis-à-vis companies discussed in his column. Foreknowledge of a broker’s, analyst’s, or columnist’s total compensation schedule enables those

8. Carpenter, 791 F.2d at 1033.
to whom he has directed a recommendation to evaluate the information’s authenticity, at least in part, by the disinterestedness of its preparer. This feature is particularly important in the case of “soft information,” which is at the heart of most analysts’ recommendations. It is difficult, if not impossible, to verify such “soft information” with other, independently obtained information. Thus, one reading Winans’s column or receiving a broker’s recommendation may accord significantly less credibility to a buy recommendation if he were aware that its preparer had recently acquired the recommended stock with the intention to sell it, and the recommendation alone, if widely followed, would cause the price of the stock to rise modestly.

If a broker were permitted to trade secretly in advance of his recommendations, he would be able to escape some of the disciplining forces that otherwise operate to stimulate fair and reasonably based recommendations. A broker’s incentive to retain his clientele through thoughtful, sound recommendations is weakened whenever a significant portion of his total compensation package is garnered by a secret trading agenda that abuses his clients’ reliance upon his recommendations.

Of course, a broker in such a situation is still subject to the disciplining forces of the marketplace: a broker engaging in such activity will soon lose his clients—just as a columnist such as Winans will lose his readers. Any column written by Winans certainly would suffer a decline in its readership if his advice became corrupted or dominated by his secret trading agenda and those persons relying upon the column were disserved by its contents.

The disciplining forces of the marketplace, however, are not enough. Forcing Winans to disclose his secret agenda in his column would have permitted the column’s readers to self-insure against Winans’s abuse by discounting, somewhat, the credibility of the column. The readers then would have been able to undertake a more thoughtful consideration of the column’s contents in light of other information known or available about the companies discussed by Winans.

Thus, we see the traditional concern with scalping. Scalping incurred its strongest proscription in *SEC v. Capital Gains Research Bureau, Inc.*, in which the Supreme Court held an investment adviser violated the antifraud provision of the Investment Advisors Act of 1940. He did so by frequently purchasing shares of a company's stock prior to recommending the stock to his clients without disclosing his trading practices to his clients. The Court reasoned that if scalping were not prohibited, an investment adviser might be encouraged to engage in the manipulative practice of proffering recommendations of companies whose characteristics were more likely to produce a quick and substantial change in the price of the company's stock following the recommendation. The Court emphasized that the disclosure of an adviser's trading practices would enable his clients to assess the strength of a recommendation because the client would be made aware that the adviser is serving two masters, one of which is his own self-interest, and ultimately he can serve only one of them. To be sure, Winans and his publisher were beyond the reach of the Investment Advisors Act, but in cases such as *SEC v. Campbell*, similar conduct by a columnist has been prosecuted by the SEC under the antifraud rule of the Securities Exchange Act.

It would have been far better to have prosecuted Winans under the scalping theory than the misappropriation theory. Not only is the scalping theory more consistent with prior Supreme Court reasoning, but it also more directly connects Winans's misbehavior with the traditional concerns of the federal securities laws. Although it is an important and indispensable utilization of

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13. *Id.*
15. The *sine qua non* of scalping is a recommendation. Absent a recommendation, the adviser's, broker's, or columnist's trading lacks any informational value; the trading has no impact on an investor's decisionmaking. If there is not a recommendation, there is no information presented to the investor for which knowledge of its creator's trading agenda would enable the investor to assess the information's authenticity. See Fleischer, Mundheim & Murphy, *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 786, 828-35 (1973). It also should be emphasized that, because the focus of a scalping violation is that the target of the recommendation or column is deprived of infor-
SEC enforcement resources to test the frontiers of the federal securities laws, promotion of this goal should not result in losing sight of the overall function of the federal securities laws. In any event, such testing always should be done with the view that the exploration will, however disposed, result in a reduction of uncertainty in the law. Because of the uniqueness of the facts in Carpenter vis-à-vis other misappropriation cases, it is difficult to justify the government's decision to proceed against Winans under the misappropriation theory based on the belief or expectation that the facts would afford a definitive resolution of the viability of the misappropriation theory. Thus, it appears that the government's decision to utilize the misappropriation theory was driven by a weak regard for anchoring violations in the traditional concern of facilitating informed investor behavior.

Some have argued that scalping was not available as a theory for prosecuting Winans because of First Amendment protections enjoyed by the press. The scalping theory, however, should survive any First Amendment attack. Unlike the prosecution in the case of Lowe v. SEC, in which the Supreme Court chose to avoid a difficult First Amendment question by holding that Lowe, who had disseminated an investment letter, was not an investment adviser and therefore was excluded from the Investment Advisors Act's registration requirements, prosecution under the scalping theory does not involve any level of registration or prior restraint. The law under this theory merely prescribes the disclosures necessary to avoid a recommendation's being considered materially misleading.

Moreover, even though the courts have held that a columnist's recommendation is not commercial speech and therefore is entitled to greater constitutional protections, the level of regulation imposed under a scalping theory would not violate the First

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17. Lowe, 472 U.S. at 206, 211.
Amendment. The collateral disclosures compelled by the scalping theory are similar to the disclosures politicians are compelled to make respecting their campaign contributors; the courts have held that the First Amendment does not immunize those engaged in the political process from being required to disclose their benefactors.\textsuperscript{19} Whether the potential private agenda be that of a columnist or a politician, compelling disclosures does not violate the First Amendment when the forced disclosures reveal information that allows investors or the electorate to assess the intrinsic worth of an analyst's or politician's message by knowing whether the message is driven by a desire for pecuniary gain.

In \textit{Buckley v. Valeo},\textsuperscript{20} the Supreme Court adopted this view by upholding the constitutionality of the 1974 amendments to the Federal Election Campaign Act of 1971, which, \textit{inter alia}, required the reporting and disclosure of political contributions by politicians and their election committees. The Court found that the governmental interest served by the disclosure requirements outweighed any possible infringement of the candidates' or their supporters' First Amendment rights.\textsuperscript{21} Importantly, the Court believed that disclosure first

\begin{quote}
provides the electorate with information "as to where political campaign money comes from and how it is spent by the candidate" in order to aid the voters in evaluating those who seek federal office... The sources of a candidate's financial support also alert the voter to the interests to which a candidate is most likely to be responsive and thus facilitate predictions of future performance in office.\textsuperscript{22}
\end{quote}

This justification is identical to that which supports the disclosures compelled under a theory of scalping. Second, the Court emphasized that disclosure would serve to deter corruption in that the electorate can be more vigilant as to possible post-election transgressions by a candidate if armed with information as to whom the candidate may be beholden.\textsuperscript{23} Similarly, under a scalping theory analysis, a broker's clients are more likely to scrutinize the post-recommendation behavior of a stock's price for the possibility for fraud on the part of a broker if his clients are alerted in advance.

\begin{footnotes}
\item[19.] \textit{See}, \textit{e.g.}, \textit{Buckley v. Valeo}, 424 U.S. 1 (1976).
\item[20.] \textit{Id.}
\item[21.] \textit{Id.} at 68, 71-72.
\item[22.] \textit{Id.} at 66-67 (quoting \textit{H.R. Rep. No. 564, 92d Cong., 1st Sess. 4} (1971)).
\item[23.] \textit{Id.} at 67.
\end{footnotes}
that the broker's recommendation entails a conflict of interest. Of course, the disclosure requirements must not be unreasonably burdensome and, as in the Federal Election Campaign Act, must facilitate collateral regulatory concerns. In the case of the scalping theory, the concern is the prevention of the manipulation of stock prices through a fraudulent stimulation of investor interest.

In the end, it is highly unlikely that the First Amendment imposes serious restrictions upon the utilization of a scalping theory to reach columnists, or even their publishers. Indeed, the regulatory demands under the scalping theory are no greater than those attempted to be imposed under the misappropriation theory in Carpenter; in each instance, whether under the "disclose or abstain" requirement of the misappropriation theory or under a scalping theory, the objective is disclosure of the defendant's trading agenda. To be sure, the sequence of the disclosure is different. Under scalping, the defendant may trade before the disclosure, so long as the disclosure occurs no later than when the recommendation is proffered. Under the misappropriation theory, the defendant may not trade before the disclosure. Indeed, the scalping theory actually imposes upon the defendant a somewhat lower burden than the misappropriation theory imposes. Thus, the First Amendment concern it raises is of a lower order than that raised by the misappropriation theory in Carpenter.

Finally, in addition to the scalping theory's more forthright approach to Winans's misconduct vis-à-vis the misappropriation theory, the scalping theory removes the private basis underpinning of insider trading regulation that is present in the misappropriation theory. That is, the misappropriation theory depends heavily upon the employer's own proscription of its employees' use of confidential company information. For example, the Second Circuit in Carpenter emphasized the confidentiality policy of Dow Jones & Company. Such an emphasis raises the concern of how courts, under the misappropriation theory, would grapple with a defendant if his employer, unlike Dow Jones & Company, had licensed

24. The Second Circuit in Carpenter also addressed First Amendment claims with respect to the misappropriation theory's application to a columnist, reasoning that columnists are bound like others to abide by the requirements of the law when pursuing their financial interests. United States v. Carpenter, 791 F.2d 1024, 1034 (2d Cir. 1986), aff'd on securities fraud counts by an equally divided Court, 108 S. Ct. 916 (1987).
25. Carpenter, 791 F.2d at 1033-34.
him to trade on the basis of his employer’s confidential information. The scalping theory, unlike the misappropriation theory, clearly prohibits such conduct and thus more aptly promotes well-established principles designed for the protection of investors so that private arrangements will not thwart the larger interests of the public.

II. GRESHAM’S LAW

The misappropriation theory devalues all the jurisprudence that surrounds rule 10b-5. So cheapened is its application that one should question not only further developments under the antifraud rule, but also those that have become acceptable. In the realm of insider trading regulation, the misappropriation theory poses a serious threat of swallowing the entire field. If there is a bulwark against such a crowding out, it is the tightness of the boxed categories that proscribes other mutations of the phenomenon more generally referred to as insider trading. These boxes bear titles such as “insider,” “temporary insider,” and “tippee.” But each shares the same characteristic as one deemed a misappropriator; whether the defendant is classified as an insider, temporary insider, tippee, or misappropriator, he uses inside information without the authorization of the entity that created that information. That is, each such person successfully prosecuted under rule 10b-5 could be deemed to have misappropriated the information. The danger is not that one theory may swallow all the others or that there may be problematic choices to be made respecting under which theory to prosecute a defendant. Rather, the problem is that such a highly defined level of jurisprudence has arisen with no attention being given to the policies so served.

The misappropriation theory is the quintessential illustration of this unexplained development because its purported objective is to prevent perceived unfairness to employment relationships, an objective clearly at odds with the otherwise recognized purposes of the federal securities laws. But the problem continues even when the theory is applied to insiders who fall within the more traditional application of the disclose or abstain rule. In this situation

there is a distinct discontinuity between protecting an investor’s judgment and proscribing insider trading; to wit, the investor’s decision to sell or purchase is unaffected by whether the insider is also secretly buying or selling shares in the open market. If the insider neither trades on nor discloses his confidential material information, one can nevertheless expect the investor to pursue his trading plan. Indeed, sellers are naturally disadvantaged by the nondisclosure of good news, just as buyers are disadvantaged by the nondisclosure of bad news. These considerations, however, cast no light on why the insider’s decision to trade should prompt disclosure. In the end, the insider’s secret trading is, for his opposite trader, a mere fortuity.

The source of the devaluation of the rule 10b-5 currency is a reluctance of the Supreme Court to act decisively in the insider trading cases. Its decisions reflect thinking symptomatic of a weak intellect, preferring endless categories and characterizations to a more penetrating consideration of the social utility of an individual defendant’s behavior balanced against the public benefits of compelling disclosure as a predicate to the defendant’s trading. The seeds for this thinking were planted in the quest of a majority of the Court in *Blue Chip Stamps v. Manor Drug Stores* to adopt an acknowledged rigid standard for the grant of standing in private actions under rule 10b-5. The Court based its decision on the pragmatic consideration of allowing courts to minister more easily to their crowded dockets. The preference for characterization reached its zenith in *Chiarella v. United States*, in which the conviction of a typesetter for insider trading was reversed because he had no *fiduciary* relationship with the investors of corporations in which he traded. To be sure, the theory advanced by the government in *Chiarella* was too encompassing to be workable because it would apply the disclose or abstain rule to anyone who enjoyed superior access to material nonpublic information, whether it be inside information or market information. *Chiarella*’s empty invocation of a preexisting fiduciary relationship does assure that the

30. The Second Circuit had reasoned that no one, corporate insider or not, could trade on material nonpublic information. United States v. Chiarella, 598 F.2d 1685, 1686 (2d Cir. 1978), rev’d, 445 U.S. 222 (1980).
disclose or abstain rule will not apply to "just anyone." However, it fails to reveal why such a relationship should justify applying the rule at all. It would have been far better for the Court in Chiarella to have approached the question instrumentally by asking for whose benefit the acquisition of information is conducted and why its confidentiality is justified by the facts before the Court. Upon resolving this inquiry, the Court should have addressed the equally important question of the way in which concerns that are germane to the federal securities laws are, or may be, adversely affected by the defendant's behavior. Vincent Chiarella was not the producer of the information upon which he traded; hence, his use of that information could more easily be circumscribed than that of bidders, for proscription of Chiarella's use would not interfere with the information's production. Furthermore, Mr. Chiarella's use easily could be seen as interdicting the conduct of the tender offeror. Chiarella's trading at least posed a serious threat of stimulating others to trade so that the price of the target corporation's shares would increase to a level sufficient to cause the tender offeror's acquisition costs to become more burdensome or perhaps even to cause the withdrawal of the tender offer. This is just one of several possible concerns the Court could have advanced to justify proscribing Chiarella's trading.

Ultimately, Chiarella did not result in either a revealing analysis of the purpose for regulating insider trading or in the Court's authorizing those who are not fiduciaries to trade on confidential information. Chiarella's contribution to rule 10b-5 jurisprudence is that it planted the seeds for the misappropriation theory, a theory under which the antifraud rule ultimately would reach printers such as Vincent Chiarella.31 Thus, one should ask how the cause of regulation or use of information has been advanced by Chiarella, in view that all that remains after Chiarella to guide others is tight classifications such as whether the defendant maintained something resembling a fiduciary relationship to the investors or

31. In fact, Chief Justice Burger's dissent in Chiarella firmly packed the soil around those seeds, if not around the future Vincent Chiarellas, when he reasoned, somewhat clumsily, that Mr. Chiarella's unauthorized use of the tender offeror's information violated rule 10b-5 because the rule proscribes "any fraudulent scheme" by "any person," as well as the reaping of the kind of "'undue' trading advantage" that serves no "useful function" described in the Exchange Act's legislative history. Chiarella, 445 U.S. at 240-44 (Burger, C.J., dissenting) (emphasis in original).
corporations in whose stock he trades or whether his use was unauthorized.

We would all have been better off if the Supreme Court in Chiarella had considered whether protecting the confidential information by proscribing trading based upon it was likely to yield economic benefits that accompany both the production of the information and private use by its producer. The securities laws permit a corporation contemplating an above-market tender offer for a target corporation's shares to acquire, without disclosure, a significant portion of the target's shares.\textsuperscript{32} Moreover, an investment banking firm may lawfully acquire treasury bills and other fixed return instruments in advance of its revered guru's pronouncement of expected interest rate changes—a pronouncement that can be expected to affect the price of the government securities purchased by the guru's employer.\textsuperscript{33} Both of these practices are justified by the incentive they provide for research and economic activity. Furthermore, both the tender offeror's bid and the investment banker's venture are harmed by premature revelation of their intentions. Their employees' premature trading could cause such an unauthorized revelation; for this reason such unauthorized trading is justifiably proscribed in the interest of facilitating the very transaction which created the information.

III. SEC SHOOTS ITSELF IN THE FOOT

The Supreme Court's disposition of Dirks \textit{v}. SEC\textsuperscript{34} is a partial resolution of the limits of insider trading regulation through an instrumentalist approach. In Dirks, the Court reversed the SEC's censuring of Raymond Dirks. Dirks learned from Secrist, a former officer of Equity Funding of America, that Equity Funding's assets were fraudulently overstated. In the course of an aggressive investigation, Dirks shared this information with five investment advisers who caused their clients to sell more than sixteen million dollars of Equity Funding stock. The Court's concern was that it must protect the invaluable function investment analysts contribute to the operation of securities markets through their search for

\textsuperscript{32} Securities Exchange Act of 1934, \textsection 13(d)(1) (codified at 15 U.S.C. \textsection 78m (1982)).
\textsuperscript{34} 463 U.S. 646 (1989).
material information, sometimes unaware that the information is either confidential or material. In the face of concerns such as this, the Court narrowly defined wrongful tipping, holding that unless the tip is to a friend or relative, it is wrongful only when the tipper expects a pecuniary gain from the selective disclosure. The brightness of this standard thus allows for very aggressive investigatory actions by the analyst. In fact, the Dirks standard extends to analysts a continuous "open season" on corporate officials in the analysts' quest for market-sensitive information. The Court's consideration in Dirks of the practical effects of the alternatives before it is in stark contrast to the mechanical considerations of the Court in Chiarella.

The zeal of the SEC staff in bringing an enforcement action against Dirks was driven to some extent by the absence of insight provided by the Court in Chiarella. Under the Chiarella standard, Secrist could not, as a former Equity Funding officer, have traded on his secret knowledge. Therefore, his tippee, who also had guilty knowledge, arguably also should not have been able to trade. Thus, no doubt exists that analysts have had good cause for concern over the enforcement actions of the SEC.

That the targets of the SEC's enforcement efforts for selective disclosures to analysts have been chosen somewhat whimsically was demonstrated in SEC v. Bausch & Lomb, Inc., in which Bausch & Lomb and its chief executive officer, Shulman, were prosecuted for negligently revealing to groups of analysts the negative impact that problems with the Bausch & Lomb's "Softlens" product would have on the company's performance. For weeks Bausch & Lomb was hounded by analysts for a definitive statement of the effect recalls and returns of Softlens would have on the firm. Due to fatigue and simple inadvertence, Shulman revealed the firm's internal projections. This revelation initiated a rash of trading by the analysts and, more significantly, their advisees. But for the bright-line resolution in Dirks, analysts in circumstances such as those in Bausch & Lomb could be expected to pursue less aggressively information from insiders. Dirks, rather than any re-

35. Dirks, 463 U.S. at 664.
36. Id. at 663-64.
straining forces within the SEC,\textsuperscript{38} prevents analysts from legitimately fearing that their use of such information may violate the securities laws. Due to the \textit{Dirks} "pecuniary gain" standard, a significant level of subsidization of analysts' conduct arises through the law's permissive treatment of the information their investigative efforts unearth.

IV. \textbf{What Is the Menace of the Court's Miscues?}

\textit{Chiarella}'s emphasis on the necessity of a fiduciary relationship is the linchpin in the current drive toward defining insider trading. Vincent \textit{Chiarella}'s escape from the disclose or abstain rule hastened the need for a surrogate approach, namely the misappropriation theory, to reach those who secretly trade on another's market information. One should not be content that the ongoing activities of Congress will salve the unease regarding the misappropriation theory's viability that exists due to the menacing shadow cast upon it by \textit{Chiarella}. Not only does purity require that any proscription of one's misappropriation of another's information be justified in terms of the well-recognized objectives of the federal securities laws, but whatever regulation of insider trading Congress enacts also should displace \textit{Chiarella}'s emphasis on a fiduciary relationship. This emphasis has had a menacing influence on rule 10b-5's application to problems not involving insider trading.

Rule 10b-5's vague proscriptions facilitate its application to a wide array of deceptive practices related to securities transactions. There is a tendency within the case law to introduce some level of discipline, if not purpose, into its application to novel forms of misbehavior by relying upon certain elements that others have recognized as indispensable for a violation of the rule. Each element and its application serve as assurances of the antifraud rule's broader objective of reaching deceptive practices. Therefore, emphasis is given to the meaning of materiality, to the plaintiff's reliance, and to an attempt to anchor the violation in what is at

\textsuperscript{38} Significantly, both S. 1380 and the SEC compromise bill fail to condition the "wrongfulness" of a tip upon the tipper's receipt of a pecuniary gain. Therefore, each bill would add greatly to the uncertainty of whether a selective disclosure was wrongful. \textit{See} Testimony of Professor James D. Cox Before the Securities Subcomm. of the Senate Comm. on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 4-5 (Dec. 15, 1987).
the heart of a securities transaction—an ever-increasing concern that the deception occur "in connection with the purchase or sale" of a security. Although such tailoring of rule 10b-5 is justified in order to assure coherence and rationality in what otherwise would prove to be an unwieldy undertaking, Chiarella introduced a variable to these undertakings that portends an unhealthy limitation upon rule 10b-5 as well as disclosure problems that arise outside of insider trading.

Two recent cases illustrate this concern. In Windon Third Oil and Gas Drilling Partnership v. Federal Deposit Insurance Corp., the complaint alleged that several partnership investments were made on the strength of representations made by Mr. Snipes, a partner in the accounting firm of Peat, Marwick, Mitchell & Company. Snipes had expressed his firm's high opinions of Clifford Resources, Inc., a management company that was being hired to explore, develop, and operate the various partnerships. The complaint alleged Snipes had represented that Clifford Resources enjoyed a positive cash flow; Snipes's working papers, however, reflected that Clifford Resources recently had experienced a cash flow deficit.

The Tenth Circuit Court of Appeals reasoned that Snipes had not violated rule 10b-5 even though he had committed a misrepresentation. Relying upon Chiarella, the court held that the obligation to disclose material information arises only when there is a preexisting fiduciary relation between the parties. Since the plaintiff had failed to allege any relationship of trust and confidence between the plaintiff and the defendant, the court dismissed the action. In doing so, the court expressly rejected the sound approach that once Snipes had voluntarily communicated some information, he was under a duty to provide enough additional information to prevent the volunteered information from being misleading.

A more sweeping limitation appears in Deutschman v. Beneficial Corp., in which an options trader incurred a substantial loss

40. Windon, 805 F.2d at 346-47.
41. Id. at 347.
42. Id.
43. Id.
when he purchased options in reliance upon a series of false financial reports released by the corporation. The court dismissed the complaint, reasoning that Chiarella requires the corporation to have a transactional or fiduciary relationship with the plaintiff as a prerequisite for the corporation’s duty to make truthful disclosures.\textsuperscript{46} The court’s reasoning apparently would also preclude suit by purchasers of the corporation’s bonds, whose purchases were induced by the corporation’s false representations:

Although both shareholders and options traders are affected by the corporation’s performance, the brute fact is the corporation is run only for the benefit of shareholders, not options traders. The relationship between shareholders and the corporation is one of trust and confidence, giving rise to a duty owed by the corporation. The nonexistence of a relationship between options traders and the corporation precludes such a duty.\textsuperscript{46}

The message of Windon and Deutschman is that courts fail to understand that insider trading is a special problem under the federal securities laws, the proscription of which to date has been justified solely out of concern for deception once a disclosure duty has been selectively imposed. This observation reflects that insider trading regulation has been in need of legitimization for some time, and certainly so after Chiarella’s emphasis of a fiduciary relationship, because of the lack of coherence in establishing the insider’s or misappropriator’s disclosure duty. Congress, in proscribing insider trading, should not repeat past sins. The folly of Windon and Deutschman is that both courts failed to consider a broader objective of regulation—truthful disclosure practices.\textsuperscript{47} Both also failed to consider how omissions and misrepresentations harm those who participate in the securities markets. The emphasis in proscribing

\textsuperscript{46} Perhaps one can more easily rationalize why options traders should not be able to recover their losses from insiders who contemporaneously trade in an issuer’s common stock when one acknowledges that it is highly problematic that any contemporaneous trader is harmed by the insider’s trading. See, e.g., Laventhal v. General Dynamics Corp., 704 F.2d 407 (8th Cir.), cert. denied, 464 U.S. 846 (1983). Nevertheless, in Laventhal the SEC pursued General Dynamics Corporation, the issuer, for disclosure violations committed in connection with the repurchase of 157,500 shares of its stock for its management incentive stock program. Id. at 409 n.2.

\textsuperscript{46} Deutschman, 668 F. Supp. at 362.

\textsuperscript{47} Immediately prior to publication of this Article, the Third Circuit Court of Appeals so reasoned and reversed. Deutschman v. Beneficial Corp., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) \* 93,656 (3rd Cir. Mar. 7, 1988).
insider trading should be upon the way in which such regulation contributes to the integrity, efficiency, and fairness of the securities markets. The menace of Chiarella is its embrace of the empty standard of a fiduciary relationship as the litmus for regulation. The emptiness of that standard’s application to insider trading appears to have infected other areas of rule 10b-5 jurisprudence. A sound rationalization of insider trading regulation hopefully may curb the unwise trend of artificially narrowing rule 10b-5’s application by the interjection of a fiduciary relationship requirement as a condition for honest disclosure practices. Such a worthwhile rationalization would emphasize the disclosure objectives served by regulating insider trading as well as how such regulation contributes to the overall integrity, efficiency, and fairness of the capital markets.