THE REGULATION OF INSIDER TRADING: A COMPARATIVE ANALYSIS OF THE LIABILITY OF NON-TRADITIONAL INSIDERS

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ABSTRACT

This comparative study is concerned with the extension of insider trading liability beyond traditional insiders, that is, directors, senior officers and major shareholders, to non-traditional insiders. Case law of the United States is examined prior to and following the leading cases of Chiarella and Dirks which addressed the issue of liability of such insiders. Also considered are the various theories advanced to justify the regulation of insider trading; the corporate fiduciary theory, the equal information theory, the equal access theory, and the developing misappropriation theory. An evaluation of the rationales for the extension of insider trading liability to non-traditional insiders who may possess informational advantages is made. This study then considers the insider trading laws of Ontario and in particular the limited effectiveness of those laws in regulating the activities of non-traditional insiders. The relevant Ontario case law and rationales for regulation are examined. This thesis suggests that developing case law in the United States may assist in anticipating inherent problems involved in the extension of liability to non-traditional insiders in Ontario.

ABREGE

Cette étude comparative traite l'extension de la responsabilité des initiés a l'égard des opérations sur titres; responsabilité qui va au delà de celle des initiés traditionnels (c'est-à-dire, les directeurs, certains fonctionnaires, et les principaux actionnaires), jusqu'aux initiés pas traditionnels. La jurisprudence des Etats-Uni est examinée avant et après les arrêts importants de Chiarella et Dirks qui s'adressent à la responsabilité de tels initiés. Les théories diverses qui sont proposées pour justifier la réglementation des opérations sur titres par des initiés sont considérées aussi; c'est-à-dire la théorie d'obligation fiduciaire de la corporation, la théorie d'égalité des reseignements, la théorie d'égalité d'accès, et la théorie de détournement qui se developpe actuellement. Une évaluation est faite des raisons pour l'extension de la responsabilité des initiés a l'égard des opérations sur titres jusqu'aux initiés pas traditionnels qui peuvent être renseignés d'avantage. Cette étude considère les lois d'Ontario au sujet des opérations par les initiés, en particulier, leur efficaçité limitée sur les activités des initiés pas traditionnels. La jurisprudence en Ontario, à ce sujet, ainsi que les raisons pour la réglementation sont examinées. Cette thèse suggère que la jurisprudence qui se développe aux Etats-Unis peut nous aider à prévoir les problèms inhérents à l'extension de responsabilité aux initiés pas traditionnels en Ontario.

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CHAPTER I

INTRODUCTION

A central feature of the capital market system in an advanced economy is the securities industry. Investors in that industry depend upon accurate and reliable information in order to make wise investment decisions. The protection of this investing public is the underlying purpose of securities legislation governing the practices and operation of the securities market. Such legislation must also take into account the economic factors involved in the operation of that market, namely, that to achieve maximum efficiency there must be prompt disclosure of material and significant information relating to the securities of companies. Insider trading laws have developed to restrict the use of material non-public information in connection with the sale of securities. These laws are generally based on the premise that the use of such information undermines the expectations of investors for fairness and equal opportunity in the market. These expectations are the foundation of public confidence in the securities market.

This comparative study is concerned with an examination of insider trading laws and resultant case law of the United States, and Ontario. It focuses particularly on the extension of insider trading liability beyond traditional insiders, that is, directors, senior officers and major shareholders, to non-traditional insiders.

This review of insider trading laws in these jurisdictions will examine the nature of the laws as they have been judicially interpreted, and the underlying rationale for such regulation.

The development of case law, especially that based upon statutory regulation of insider trading, has occurred principally in the United States since the passage of the Securities Exchange Act of 1934. A wealth of legal and economic commentary has followed this development. This study selectively reviews this commentary, in particular as it relates to the landmark Supreme Court decisions in Chiarella v. United States, and Dirks v. S.E.C. and the implications these decisions have for the extension of insider trading liability to non-traditional insiders.

This study suggests that American case law in this area may provide those concerned with securities regulation in Ontario with cogent examples of the inherent problems encountered in the broadening of insider liability.

Before proceeding with the review of the case law, the definition of terms relevant to insider trading is necessary.

(a) INSIDER TRADING TERMINOLOGY

(i) Insider Trading Defined

Insider trading has been defined as:

> "purchases or sales of securities of a company (or other issuer) effected by or on behalf of a person whose relationship to the (issuer) is such that he is likely to have access to relevant material information concerning (it) not known to the general public."[1]

This definition will be used in this study, subject to further discussion and qualification.

(ii) Insider Trading - Key Concepts

Insiders

Only insiders are prohibited from trading with material inside information so it is important to review what is meant by that term. The determination of "insider" status depends upon the "existence of a relationship affording access to inside information intended to be available only for a corporate purpose."[2] The concept of insider includes directors, officers, shareholders and in some instances lower-level employees and independent contractors ("quasi" or "temporary" insiders)[3].

Outsiders

Someone who does not have the access, directly or indirectly, to information intended to be available only for a corporate purpose. The securities legislation regarding insider trading takes into account the unfairness involved in the market when an insider takes advantage of material information knowing it is unavailable to others in the market place ("outsiders").

Materiality

In SEC v. Texas Gulf Sulphur ("TGS")[4] the Court defined "materiality" as a fact which would be of interest to a "reasonably prudent investor". The "materiality" concept in TGS has four different components, namely:

(a) Facts which, if disclosed, would be reasonably likely to have substantial market effect;

(b) Facts which would be important to reasonable investors;

(c) Facts which are 'material' upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity;

(d) The importance attached to the facts by those who know of them as reflected by the manner in which they trade securities.[5]

Tipper

A tipper is the person who provides the market tip to the tippee. Before a tipper can be held liable, it must be established that (1) he was aware he was communicating material nonpublic information and (2) he knew or recklessly disregarded a substantial likelihood that the person receiving the information would either trade on the basis of it or pass it on to another for trading purposes.[6]

Tippee

Tippees - persons who are "tipped off" about confidential corporate information from an insider with knowledge of its source.[7]

CHAPTER I

FOOTNOTES

1. Report of the Attorney General's Committee on Securities Legislation In Ontario (Toronto: Queen's Printer, 1965) (Chair: J.R. Kimber) para. 2.01.

2. Chiarella v. U.S. 445 U.S. 222 (1980) at 227.

3. H.T. Wilkinson, "The Affirmative Duty to Disclose After Chiarella and Dirks" (1985) 10 J. Corp. L. 581, at p. 584, n. 18.

4. 401 F. 2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

5. 401 F. 2d at 852.

6. D.C. Langevoort, "Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement" (1982) Cal. L. Rev. 1 at 26.

7. T. Hadden, R.E. Forbes and R.L. Simmonds, Canadian Business Organizations Law (Toronto: Butterworths, 1984) at 465.

CHAPTER II

INSIDER TRADING - CONCEPTS & LEGISLATION

(a) INTRODUCTION

Prior to reviewing the judicial interpretation of statutory regulation of insider trading, it is instructive to review the U.S. federal common law rules relating to such trading.

(b) COMMON LAW RULES

> "The general common law rule is that insider trading in publicly traded corporations is permitted. Failure by an insider to disclose information before trading is not actionable. Neither the corporation nor an investor trading in the opposite side of a transaction to the insider has any legal remedies against the insider."[1]

This general common law rule has some exceptions. Some jurisdictions allow suits against insiders for trading if the plaintiff can prove "special facts" - that his trade was induced by express or implied misrepresentations concerning the value of the securities or the identity of the purchaser.[2] A commentator noted that in these cases the "plaintiff sought to extend the tort of misrepresentation to reach material non-disclosure of corporate information".[3] In Strong v. Repide, a former shareholder of a sugar company had been induced to sell shares to a person who (unknown to the shareholder) was the company's general manager and knew that the company was about to enter an extremely profitable contract with the government. The Supreme Court granted rescission to her under the " special facts" doctrine.

> "Although tort law generally prohibits only affirmative misrepresentations and half-truths and does not create an affirmative duty to offer all material information the special facts of this case, such as the defendant's inside position and the significance of the information, compelled disclosure."[4]

The special facts rule was refined and expanded in later cases to place on all corporate officers and directors a general obligation of affirmative disclosure when dealing with shareholders in recognition of the fiduciary status that exists between them.[5]

At common law, therefore, the "majority rule", or "strict" rule, did not recognize any affirmative duty to disclose when a director possessing inside information engaged in a securities transaction with shareholders.[6] But something called the "minority rule"[7] has evolved. In many jurisidictions, an affirmative duty to disclose was imposed on insiders in certain situations under the common law:

> ". . . there are two strains running through the common law cases imposing an affirmative duty: first, that there is a special relationship between the trading parties such that a fiduciary duty arises; second, due to one's status as an insider, there is an independent fiduciary duty not to trade on confidential information in the quest for personal profit."[8]

As will be seen, the Supreme Court in Chiarella and Dirks, by adopting the Cady, Roberts access test, has assimilated into federal law the common law minority rule, rather than the majority rule.[9]

(c) INSIDER TRADING UNDER THE SECURITIES ACT

> "While rooted in common law concepts and state corporations law, the law of insider trading has developed principally under Section 10(b) of the Securities Exchange Act of 1934 and rule 10(b)-5 promulgated thereunder."[10]

The original Securities Exchange Act of 1934 contains a general provision, Section 10(b), that governs the purchases or sales of securities. It was drafted as a "catch-all" provision designed to "allow the Commission wide latitude to adopt rules and regulations proscribing manipulative devices."[11] Under Section 10(b), "It shall be unlawful for any person directly or indirectly, by 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 or for the protection of investors.[12]

Section 17 (a) of the Securities Act of 1933[13] addressed fraud by sellers of securities but there was no similar antifraud provision with respect to purchasers until rule 10(b)-5 was created by the Commission in 1942.

"The rule was promulgated in response to a specific instance of a manipulative purchaser. Although it was designed merely to close this purchaser loophole the rule, through administrative and judicial interpretation, has been cast in the role of the preeminent antifraud provision of the federal securities laws."[14]

The Rule states:

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,

(a) to employ any device, scheme or artifice to defraud;

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[15]

The language of Rule 10b-5 specifically prohibits false and misleading statements or an omission of a material fact where some statements are made.

"There is nothing in the rule itself to indicate that any person has an affirmative duty to disclose material facts under rule 10b-5. However the Commission and the courts have interpreted rule 10b-5 as requiring affirmative disclosure in certain instances."[16]

Under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. s 78p(b) (1976) short-swing profits by certain insiders is prohibited. This rule has been called the "insiders short-swing profit" rule and it is designed to reach more specific insider trading practices. Liability does not depend on any showing that the insider actually possessed any material non-public information. Section 16 requires directors, officers, and large stockholders (owning over 10% of the firm) to report trades in equity securities of their firm on a monthly basis. Section 16 differs from section 10(b) and Rule 10b-5 in several major respects:

(1) Section 16 does not require trading on inside information for an action to lie - any short term profits made by buying and selling are recoverable;

(2) its scope is limited to the 6-month period;

(3) it makes only specific insiders liable; and

(4) it allows only the firm to recover.[17]

> "Because of its relatively narrow scope, it does not provide an effective remedy for the full range of insider trading abuses. However, it does evidence a congressional policy against insider trading, and the section is limited because of difficulties of proof rather than a judgment that trading not expressly covered should be permitted."[18]

Rule 10b-5 has been called the "primary weapon in the fight against insider trading".[19]

(d) SANCTIONS CONCERNING INSIDER TRADING:

As this study focuses on the extension of insider trading beyond traditional insiders and the supporting rationales for same, the following review is necessarily limited in its scope.

(i) Prior to passing of Insiders Trading Sanctions Act 1984

Prior to passing of the new legislation, the maximum civil penalties upon conviction of the offence of insider trading were:

(1) the disgorgement of profits as sought by the SEC;

(2) the Commission had ancillary relief in an action for an injunction against future violations.

The maximum criminal penalty was a $10,000 fine and a possible five-year jail term. The SEC is only empowered under Federal Statute to bring civil actions so that criminal actions are prosecuted by The Department of Justice. Criticism of the mild penalties imposed as a result of the Commission's enforcement actions stressed the lack of deterrence that necessarily followed:

> "SEC civil actions were common but courts effectively limited relief to disgorgement of profits and an injunction against future violations. In light of the difficulty of catching insiders who trade in the first place, these SEC civil actions were not seen as an effective deterrent."[20]

With regard to the disgorgement of profits, as is later noted in the Texas Gulf Sulphur case[21] the Court ordered, in addition to an injunction as ancillary relief, that the defendant disgorge to the corporation the profits realized by them and their tippees by trading on inside information. The corporation itself could not sue for such relief since it was neither a purchaser nor a seller of securities and was therefore unable to maintain a claim for damages based upon Rule 10b-5. The corporation may, however, have been able to recover from the insiders in a derivative action based upon state corporate laws.[22] In Texas Gulf Sulphur, the principal beneficially was the corporation itself, because the insiders' profits were credited to the fund that the corporate defendant agreed to pay in settlement to abused investor plaintiffs. More recently, however, insiders have turned over profits directly to those persons adversely affected by the insider trading.[23]

As for the ancillary relief of an injunction, this can be quite a serious remedy in its effects. If the decree probited all further misuse of inside information relating to all securities transactions, a securities firm would constantly run the risk of being held in contempt unless it had extensive safeguards against the misuse of inside information. However, most injunctions are narrowly drawn to cover only the securities of a specific corporation. Hence the effectiveness of the injunction is, in practice, limited.[24]

(e) PRIVATE ACTIONS IN DAMAGES

While initially Congress provided relatively few civil remedies for securities law violations, the major role that damage suits have come to play has resulted in a hybrid of public and private enforcement. Private enforcement has developed purely from judicial implication of civil remedies to complement or supplement Commission regulation, and rarely duplicate methods of enforcement. An example of such a combination is the high degree of voluntary compliance with disclosure requirements mainly motivated by fear of incurring liability in private suits (per Section 11. Securities Act of 1933 para. 11, 15 U.S.C. para. 77k (1976).[25] A commentator has noted that "private actions are largely parasitic" in relation to SEC-initiated action.[26]

(f) INSIDER TRADING SANCTIONS ACT OF 1984[27]

On August 10, 1984, in response to "bipartisan political support"[28] both in the SEC and Congress, the SEC was given a new remedy to assist it in agressive enforcement of insider trading in the form of the Insider Trading Sanctions Act. This Act added Section 21(d)(2) to the Securities Exchange Act of 1934 to give the SEC the authority to seek civil penalties against persons who contravene the prohibition against insider trading of up to three times the profits made, or losses avoided by the trade.

Section 21(d)(2) defines the proscribed trading in the following terms:

> Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (i) on or through the facilities of a national

> securities exchange or from or through a broker or dealer, and (ii) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States district court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such persons, or any person aiding and abetting the violation of such person.

The civil penalty can be imposed only by the SEC so that private parties cannot seek relief based on provisions of the Act.

The new Act does not set guidelines for the exercise of the Court's discretion in determining the amount of the penalty. In proposing the legislation, the SEC stated only that the amount should be determined "in light of the facts and circumstances".[29]

> "Presumably, the issue will be resolved, much the way it is resolved in other criminal and civil fine contexts, by taking due account of the financial resources of the defendant, and related common factors. Based on the strong legislative expression of the need for deterrence and the difficulty of detection of criminal infractions, it is appropriate - at least insofar as the sophisticated trader is concerned - to treat the 300% civil penalty figure as the rule, not the exception."[30]

Another important point about the penalty is that it may be collected in addition to any other remedies directed against the offender so that the SEC could obtain "both disgorgement of profits and treble profits as a penalty - for all practical purposes, a quadruple profits sanction.[31] Since it is a civil penalty:

(1) proof of the violation has to be only a preponderance of the evidence: and

(2) non-payment of the penalty will not result in imprisonment.[32]

If one fails to pay, the Attorney General is authorized to bring an action in U.S. District Court to recover the amount of the penalty. It should be noted that Congress followed the SEC's submission, and did not legislate a definition of "insider trading".

The substantive elements of a violation of rule 10b-5 were not intended to be affected by the new law. A commentator has noted that a "familiar canon of statutory construction" is that when a statute fails to change "the prevailing judicial construction of some prior enacted provision, that failure constitutes an implied endorsement of judicial interpretation, at least to the extent that Congress was aware of the construction and there was a natural opportunity for revision."[33]

The same commentator argues that this maxim applies to the 1984 Act:

> "Congress hardly could be expected to enhance so considerably the enforcement capacity of the SEC when it was dissatisfied with the substantive ground on which the Commission could bring its actions. Indeed, the legislative history shows that the drafters demonstrated a substantial familiarity with the prevailing law, actively considered addressing the law, but determined not to do so.[34]

That is one theory, that refraining from statutorily defining insider trading indicates that the Congress approved of judicial development of the definition. Another theory, is that Congress could not agree on what that definition should be. Securities Exchange Commissioner Joe Grundfest has these comments on the passing of the Insider Trading Sanctions Act:

> "The current state of the law on it (insider trading) is a terribly confused morass. When Congress passed the Insider Trading Sanctions Act, it couldn't agree on how to define insider trading, and yet it's subject to treble damages."[35]

This latter statement reflects one view of the present state of insider trading law and the fact that case law above has attempted to define what insider trading is. How judicial interpretation of the securities legislation has developed will be reviewed below.

CHAPTER II

FOOTNOTES

1. D.W. Carlton, and D.R. Fischel, "The Regulation of Insider Trading" (1984) Sec. L. Rev. 257 at 283.

2. Strong vs. Repide, 213 U.S. 419 (1909).

3. D.C. Langevoort, "Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement" (1982) 70 Cal. L. Rev. 1 at 26.

4. Ibid. at 5.

5. Ibid.

6. H.T. Wilkinson, "The Affirmative Duty to Disclose After Chiarella and Driks" (1985) 10 J. Corp. L. 581 at 582.

7. Ibid. at 595.

8. Wilkinson, supra, note 6 at 595.

9. Ibid. at 597.

10. Langevoort, supra, note 3 at 2.

11. Wilkinson, supra, note 6 at 582.

12. 15 U.S.C. para. 78j (1982).

13. 15 U.S.C. para. 779 (1982).

14. Wilkinson, supra, at 582.

15. 17 C.F.R. para. 240.106-5C (1984).

16. Wilkinson, supra, at 583.

17. D.W. Carlton, D.R. Fischel, supra note 1, at 291.

18. Langevoort, supra, note 3 at 3, note 7.

19. Wilkinson, supra, note 6 at 582.

20. D.C. Langevoort, "The Insider Trading Sanctions Act of 1984 and Its Effect On Existing Law" (1985) 17 Sec. L. Rev. 187 at 189.

21. 312 F. Supp. 77 (1968).

22. H.S. Bloomenthal, Securities Law Handbook (New York: Clark Boardman Co. Ltd., 1985 - 86) at 334.

23. M.P. Dooley, "Enforcement of Insider Trading Restrictions" (1980) 66 Va. L. Rev. 1 at 14, and note 72.

24. Ibid. at 13, 14.

25. Ibid. at 15.

26. Ibid. at 16.

27. Pub. L. 98-376, 98 Stat., (264 (1984).

28. Langevoort, supra, note 20 at 189.

29. Ibid. at 192.

30. Ibid. at 192, 193.

31. Ibid. at 195.

32. Bloomenthal, supra, note 22 at 1 xxxvi.

33. Langevoort, supra, note 20 at 188.

34. Ibid.

35. "Joe Grundfest Speaking, Listen To The Newest SEC Commissioner". Barron's (28 October, 1985) 28.

CHAPTER III

CASE LAW REVIEW

(a) PRE-CHIARELLA and DIRKS

Shortly after Rule 10b-5 was created in 1942, the Securities and Exchange Commission had "the opportunity to consider the rule's limitations on insider trading"[1] in Ward La France Truck Corporation.[2]

(i) Ward La France Truck Corporation (SEC 1943)

This case involved two individuals who were officers, directors and controlling shareholders of a public owned company. They entered into a plan to purchase outstanding shares while they simultaneously negotiated to sell the Company to a third party. The two insiders did not disclose to the public shareholders from whom they acquired shares:

(a) the improved operating condition of the truck corporation;

(b) the proposed sale and liquidation of the truck corporation at a greatly inflated price;

(c) the identity of the purchasers.

The Commission was concerned with the propriety of the methods used by insiders in this case to purchase shares from the shareholders.[3] The Commission issued a report pursuant to Section 21(a) of the Securities Act[(4)] in order to draw attention to the newly created Rule 10b-5 and its application in such situations.

The Commission, after reviewing the facts of the case, held that there had been a 10b-5 violation:

> "in this case, therefore, there was a clear necessity, in order not to take unfair advantage of shareholders, for the issuer

and those in control to make timely disclosure of the identity of the purchaser, of improved financial and operating condition of the issuer, and of the full terms of the transfer to Salta of the Truck Corporation's business and of its liquidation."[5]

The Commission therefore held that the purchase of the securities in the circumstances of this case, that is, without appropriate disclosure of material facts, constituted a violation of Rule 10b-5.

(ii) Kardon v. National Gypsum Co. (E. D. Pa. 1947)[6]

This case is widely considered as the first to recognize an implied right of action for a private party under Rule 10b-5; it is also notable for its relation of that right to common law fiduciary principles.[7] The plaintiffs in Kardon, Morris and Eugene B. Kardon (father and son), and the defendants, Leon Slavin and William Slavin (brothers), owned all the capital stock of Western Board and Paper Co. and its affiliate Michigan Paper Stock Co. Each of the four held one fourth of the shares of these closely held corporations. The defendants, who were also corporate directors, negotiated a sale of corporate assets to a third party and thereafter, without disclosing this material fact, purchased the stock owned by the plaintiffs and completed the sale to the third party for their own benefit. The action was brought by the Plaintiffs against National Gypsum Company, a Delaware corporation, and others, to recover damages for fraudulently conspiring to induce and inducing the Plaintiffs to sell their stock in the two corporations for less than its true value. The Plaintiffs obtained a decree for an accounting:

> "The plaintiffs' case was established when the defendants' duty and its breach were proved. This was done by showing that the defendants were officers and directors of Western and that they disposed of the bulk of the corporate assets to an outsider, for their own benefit, without disclosing the transaction to the plaintiffs or giving them an opportunity to participate in it. The remedy follows, which, in this case, is an accounting to ascertain and restore to the plaintiffs their proportionate share of the profits, if any."[8]

The court held that the insiders were "analagous to trustees" with a duty under "well-known and well-established equitable principles governing fiduciary relationships."[9]

> "Kardon was the initial application in a 10b-5 nondisclosure case of what may be termed fiduciary principles of corporate trust and loyalty. The Court, relying on common law principles, held for the first time that an insider who uses nonpublic corporate information for personal enrichment will be liable under rule 10b-5 . . ."[10]

(iii) Speed v. Transamerica (D. Del. 1951)[11]

Transamerica was a large, powerful investment company. Axton-Fisher was a small tobacco company, the controlling shares of which were purchased by Transamerica for one million dollars. The parent corporation had made a written offer to all minority stockholders of the subsidiary to purchase their share, at fixed price, while at the same time entertaining undisclosed intent to liquidate the subsidiary and thereby realize an inventory which had appreciated far in excess of the carrying value of inventory shown in the annual report to the stockholders. It was the plan of Transamerica, to capture the market value of the Axton-Fisher inventory by merging, dissolving or liquidating Axton-Fisher, that was a crucial finding in this case. Non-disclosure by the controlling shareholder to the minority shareholders of the increased value of the tobacco inventory in the light of the existence of such a plan was held to constitute a violation of Rule 10b-5. Judge Paul Leahy of the Federal District Court stated:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority shareholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position, but not known to the selling minority stockholders . . ."[12]

Judge Leahy held that the duty of disclosure arose from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders.

> "It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgement in any transaction. Some courts have called this a fiduciary duty while others state it is a duty imposed by the 'special circumstances'."[13]

Speed, like Kardon, imposed an affirmative duty to disclose upon insiders making share purchases in connection with a liquidation plan. Speed also stressed that the insider's duty to disclose was derived from fiduciary principles prohibiting the use of insider information for their own benefit and to the detriment of uninformed shareholders. However, the Court in Speed importantly indicated a second reason for the affirmative duty to disclose in face-to-face transactions. The insider's duty to disclose arose from the necessity of preventing him using his position to take unfair advantage of uninformed minority shareholders.[14]

> "Thus Speed marked a departure by emphasizing fundamental market fairness and equality of information, as well as fiduciary principles of corporate trust and loyalty."[15]

(iv) In Re Cady, Roberts & Co. (SEC 1961)[16]

This was a very significant case in the development of case law under Rule 10b-5 and it is relied upon heavily by the Supreme Court in the two most important cases in this area of federal securities legislation, Chiarella and Dirks.[17]

The facts of Cady were that a broker-dealer obtained insider information regarding a substantial cut in dividends by the Curtiss-Wright Corporation. The information was obtained through a registered representative of the broker-dealer firm Cady, Roberts who was also a director of Curtiss-Wright Inc. During a Curtiss-Wright board meeting, it was decided to cut the dividend in half because of new product development. The meeting adjourned to allow calls to be put through to the "New York Times", "Wall Street Journal", Dow Jones, and the New York Stock Exchange. There was an unexplained delay in the news reaching Wall Street and, during this time interval, the registered representative called one of the partners at his firm (Cady, Roberts) to inform him of the dividend news. The partner at Cady, Roberts immediately began selling shares from the discretionary accounts into the market. Chairman Cary of the Securities and Exchange Commission held that:

> "An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders', particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them, by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes a violation of the anti-fraud provisions. <u>If, on the other hand, disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, we believe that alternative is to forego the transaction.</u>"[17] (Emphasis my own)

This has become known as the "abstain-or-disclose" rule. The Chairman based this duty or liability 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."[18]

Both elements had to be present to find liability since it was the Commission's task "to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities".[19] The Commission found on the facts of <u>Cady, Roberts</u> the requisite special relationship.

<u>Cady, Roberts</u> has been seen to have expanded the 10b-5 duty to disclose in three ways:[20]

(1) A non-insider could have an affirmative disclosure obligation;

(2) In contrast to the face-to-face transactions in <u>Ward La France</u>, <u>Kardon</u> and <u>Speed</u>, in <u>Cady</u>, an affirmative duty could arise in impersonal market trading;

(3) The case confirmed a duty to disclose to persons not previously shareholders but who, by virtue of fraud in connection with the sale, became shareholders of the subject company.

The great significance of Cady, Roberts however is the creation of the new "access test".[20] The Commission did not follow the common law "majority rule" which imposed no disclosure duties upon insiders in transaction with shareholders. The decision of the SEC recognized a duty to disclose which could also apply to non-insiders and to impersonal transactions.[22]

(v) SEC v. Texas Gulf Sulphur (2d Cir. 1968)[23]

Judicial affirmation of the Cady, Roberts case came with the decision of the U.S. Court of Appeals for the Second Circuit in SEC v. Texas Gulf Sulphur (hereinafter "TGS"). This case further expanded the affirmative duty to disclose.

In TGS, company officials bought TGS stock on the New York Stock Exchange, knowing of a copper strike in northern Ontario before that information was even known by the Company's full board of directors. The information regarding the substantial copper strike was deemed to be both non-public and material. The case is important in the definition it gave to materiality and the introduction of a new category of insiders: those who have access to an issuer and yet may not be its agent or employee ("tippees"). But the TGS case is mainly significant because the Second Circuit based its decision "solely on the second part of the Cady, Roberts test - the generalized notion of market fairness and equality of information."[24]

> "The court said that it was irrelevant whether rule 10b-5 was 'predicated on traditional fiduciary concepts . . . or on the 'special facts' doctrine . . .' As far as the Second Circuit was concerned it made no difference whether the trader was an insider or even one with access to inside information. Instead, the Court ignored corporate fiduciary concepts and in an effort to implement its interpretation that rule 10b-5 was designed to provide 'relatively equal access to information' to those trading or exchanges, the Court created the 'possession test'."[24]

The court held that the affirmative duty to disclose applied not only to directors and other insiders, but:

> "this Rule is also applicable to one possessing the information who may not be strictly termed an insider within the meaning of section 16(b) of the Act . . . Thus anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."[26]

Thus the TGS "possession test" imposed an affirmative duty to disclose whether or not there was a special relationship with the corporation which afforded access to non-public corporate information.

This affirmative duty to disclose is the now-famous "disclose-or-refrain" rule. The rule requires that one in possession of material undisclosed information must either publicly disclose it or if he is unable to do so, he must refrain from buying or selling the security. The Court based its decision solely on a concept of market fairness.

The Court then found it unnecessary to determine "precisely who has been defrauded,'apparently assuming a fraud ' on the market place' was enough to support an SEC injunctive action."[27] Further, in addition to an injunction, the Court ordered the defendants, as ancillary relief to disgorge to the corporation the profits realized by them and their tippees by trading on inside information. It is noteworthy that the corporation itself could not sue for such relief since it is neither a purchaser nor a seller of securities, and therefore it cannot maintain a claim for damages based on Rule 10b-5.[28]

As for private claims for damages brought by investors, Harold Bloomenthal has noted the following:

> "While it is clear that a private claim for damages can be asserted in a face-to-face transaction, the courts are divided on whether, in anonymous transactions in the trading markets, those purchasing (or selling, as appropriate) more or less at the

same time as and on the opposite side of the market from insiders can recover damages from the insider (including tippees and those making selective disclosure), notwithstanding an absence of privity between them."[29]

Bloomenthal notes that the Second Circuit in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc. was held that such insider trading of selective disclosure is actionable. The Sixth Circuit, on the other hand, in Fridrich v. Bradford[31], has held that since the insider could refrain from trading without disclosure, in which event, plaintiffs presumably would have traded the security anyway, trading by insiders did not cause plaintiffs harm.

> "In the Sixth Circuit view, enforcement actions by the Commission are the exclusive remedy, and investors must run the risk that at any given time there may be undisclosed material developments relevant to their investment decision."[32]

(vii) Investors Management Co., Inc. Et Al (SEC 1971)[33]

This is a case in which the SEC followed the TGS trend. The facts of the case were that Merrill Lynch was the underwriter of a proposed Douglas Aircraft offering. During the period June 17 through June 22, Merrill Lynch and certain of its officers, directors and employees (the individual respondents) were advised by Douglas management of certain material adverse inside information regarding Douglas earnings. The information concerned a sharp drop in earnings and the reduction of earning forecasts. This information was given to Merrill Lynch solely because of its position as prospective underwriter. Many employees and directors of Merrill Lynch disclosed the information to their customers (mostly large institutional investors), and as a result Douglas common shares were sold on the New York Stock Exchange, and the market price of Douglas common stock dropped substantially.[34]

In this case, the SEC affirmed the finding of the Hearing Examiner that the sanction of censure be applied to the respondents. This case was the first to hold tippees civilly liable for trading on material, non-public information.[35] The

Commission rejected the contentions advanced by the respondents:

> "that no violation can be found unless it is shown that the recipient (tippee) himself occupied a special relationship with the issuer or insider corporate source giving him access to non-public information, or, in the absence of such relationship, that he had actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it.
>
> We consider that one who obtains possession of material non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the anti-fraud provisions."[36]

Thus the Commission, although not "fully embracing the possession test, placed minimal emphasis on the <u>Cady, Roberts</u> special relationship and instead founded its decision on the second more general market fairness/equality of information test of <u>Cady, Roberts</u>". [37]

It is important to note, Commissioner Smith's approach in <u>Investors Management</u>, as it was relied on by the Supreme Court in <u>Dirks.</u> Smith stressed that the affirmative duty to disclose was dependent upon two factors - a special relationship with the corporation and culpable conduct by the insiders and tippees. Commissioner Smith stated:

> "I believe the emphasis in the law should continue to be upon the conduct of corporate insiders and their privies . . . rather than upon a concept . . . of relative informational advantages in the market place."[38]

Smith stated that tippee responsibility must be related "back to insider responsibility by a necessary finding that the tippee knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information."[39]

(vii) <u>Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.</u> (2d Cir. 1974)[40]

<u>Shapiro</u> was a private suit arising out of the same facts as <u>Investors Management.</u> It was a civil action against Merrill Lynch and some of the

selling customers to recover damages sustained by the Plaintiff as a result of the defendants trading or recommending trading of the common stock of Douglas Aircraft Co. The Second Circuit Court held that buyers on an exchange could recover damages from the institutional tippee sellers for 10b-5 violations.

> "Relying on their previous decision in Texas Gulf Sulphur, the court held that the tippees were liable for damages to all persons who bought the company's shares in the open market from the period of the tippees' trades to the time the information became public. In formulating such a draconian remedy, the Second Circuit took the equality of information/fairness of markets prong to the extreme. Shapiro dismissed the need for the demonstration of any relationship, with the duties attendant thereto, between the defendants and the corporation and between the defendants and the plaintiffs."[41]

Donald Langevoort has commented that Shapiro "underscored the in terrorem potential of the insider-trading prohibition under rule 10b-5."[42] He further commented that once the law of insider trading was expanded to include tippees, the 'fiduciary duty' source of the law was called into question.[43]

> "Much as the Texas Gulf Sulphur court had suggested, the law could be perceived as dealing directly with the unfairness inherent in informational imbalances of prohibiting any trading on unshared material information except insofar as that advantage was attributable solely to the trader's superior foresight and skill."[44]

Whatever questions remained relating to the nature and source of the duty to disclose and to whom it was owed these cases (TGS and Shapiro) clearly emphasize that the aim of securities laws was to promote a fair and informed market place. But how was such fairness in the market place to be promoted? Chiarella and Dirks would subsequently provide guidance to these important questions.

(viii) Bausch & Lomb Incorporated (2d Cir. 1977)[45]

The Securities and Exchange Commission sought to permanently enjoin the manufacturer of optical products and the chairman of its board of directors from violating anti-fraud provisions of the Securities Exchange Act, claiming that the board chairman had improperly tipped securities analysts as to earning estimates and other information not available to the general public. The District Court denied the application for permanent injunction and the Commission appealed. Bausch & Lomb and Chairman, Schuman, were alleged to be the tippers, whereas the recipients of the information, MacCallum and Hoitsma, were the alleged tippees.

The case was important in that it made a determination on the question of the permissible scope of communications between a corporate officer and securities analysts.

> "Many a corporate executive, conscious of the anti-fraud provisions of the Securities Acts, may analogize an encounter with a financial analyst to a fencing match conducted on a tightrope; he is compelled to parry often incisive questioning while teetering on the fine line between data properly conveyed and material inside information that may not be revealed without simultaneously disclosing it to the public."[46]

Chief Judge Kaufman noted that materiality had become one of the "most unpredictable and elusive concepts of the federal securities laws"[47]

> "The SEC itself has despaired at providing written guidelines to advise wary corporate management of the distinctions between material and non-material information, and instead has chosen to rely on an after-the-fact, case-by-case approach, seeking injunctive relief when it believes that the appropriate boundaries have been reached."[48]

In this case, the Court held that an estimate of earnings was material non-public information but that Schuman did not convey any significant new facts to analysts concerning sales during the interviews. The U.S. Court of Appeals agreed with the trial judge that the analysts had merely tested the "meaning of public information".[49] Secondly, the Chief Judge stated that the SEC had failed to prove that Schuman had acted with scienter. He referred to the <u>Hochfelder</u>[50] decision, which held that a private cause of action will not lie under s. 10(b) and Rule 10b-5 without an allegation of scienter - that is, intent to deceive, manipulate, or defraud.[51] The <u>Bausch</u> judgment attempted to provide some guidance to corporate representatives and securities analysts, regarding the scope of liability under Rule 10b-5.

(b) CHIARELLA V. UNITED STATES (U.S.S.C. 1980)[52]

In this landmark case the Supreme Court for the first time confronted the law of insider trading under rule 10b-5.[53]

Chiarella was a printer by trade. In 1975 and 1976 he worked as a "markup man" in the New York composing room of Pandick Press, a financial printer. Among the documents that Chiarella handled were five announcements of corporate takeover bids. When these documents were delivered to the printer, the identities of the acquiring and target corporations were concealed by blank spaces and false names. The true names were sent to the printer on the night of the final printing.

Chiarella, however, was able to deduce the names of the target companies before the final printing from other information he gathered in the documents. Without disclosing his knowledge, Chiarella purchased stock in the target companies and sold the shares immediately after the takeover attempts were made public.[54] Over a period of fourteen months Chiarella saw a profit of $30,000. Eventually the SEC began investigating his trading activities and in May, 1977 he entered into a consent decree with the Commission whereby he agreed to return his profits to the sellers of the shares. He was then discharged by Pandick Press.

In January, 1978 Chiarella was indicted on 17 counts of violating s.10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. Chiarella was brought to trial and convicted and the Court of Appeals for the Second Circuit affirmed that conviction.[55] Mr. Chiarella then took his case to the Supreme Court.

(i) Significance of the Supreme Court Decision

The Supreme Court reversed Chiarella's conviction on the facts presented and in doing so "took the opportunity in elaborate dicta, to offer its own understanding of the law on this subject. While apparently reaffirming the law's basic premises, the Court has raised questions about the validity of many assumptions as to what is prohibited. In particular, Chiarella has made the fiduciary principle of utmost importance."[56]

Before the Supreme Court, the government argued two positions. First, that Chiarella through his sensitive position as a financial printer was a market insider who was therefore prohibited from trading on the basis of material non-public information obtained in that capacity. Secondly, the fact that the information had been misappropriated was a separate basis for finding his actions to be fraudulent. The government argued that Chiarella had misappropriated confidential information from Pandick's customers and in doing so had defrauded the customer. The government further argued that Chiarella had used the misappropriated information for material gain without public disclosure which was a fraud on uninformed investors who sold him securities. Importantly, the Supreme Court refused to consider these misappropriation arguments because these theories of liability had not been properly presented to the jury at trial. Instead, the Supreme Court concentrated on the "primary theory" advanced by the Second Circuit Court: "that Chiarella, as a market insider, owed a duty of disclosure to the sellers of target company shares."[57]

(ii) Justice Powell's Majority Opinion

Justice Powell began his judgment with the statement: "This case concerns the legal effect of the petitioner's silence".[58] He noted that the District Court's charge permitted the jury to convict the petitioner if they found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable.

> "In order to decide whether silence in such circumstances violates s.10(b), it is necessary to review the language and

> legislative history of that statute as well as its interpretation by the Commission and the federal courts."[59]

Justice Powell found that neither the statute nor Rule 10b-5 directly addressed the issue of silence as a basis for liability.

Rather, the Cady, Roberts decision had "broken new ground"[60] by finding that corporate insiders breached a duty to the public by taking unfair advantage of their insider status in market trading. Justice Powell restated the two-pronged access test of Cady, Roberts.[61] He stated that the duty of disclosure in Cady, Roberts was recognized because of "a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."[62] This special relationship creates a duty to disclose because of:

(a) The existence of a relationship affording access to inside information intended to be available only for a corporate purpose; and

(b) the unfairness of allowing a corporate insider to take advantage of that information.[63]

The Supreme Court thus reversed the Second Circuit's opinion and rejected the position that general notions of market fairness and equality of information were sufficient to create an affirmative duty to disclose. Rather, the focus for liability was the existence of a duty to disclose:

> "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under s.10(b) does not arise from the mere possession of nonpublic market information."[64]

Thus Justice Powell stressed the paramount importance of a 'duty to speak' in creating an affirmative disclosure obligation under Rule 10b-5.

In order for there to be actionable fraud under Rule 10b-5 there must be a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Absent such a fiduciary duty, there was no obligation to disclose prior to trading.

"Chiarella was a 'complete stranger' to the sellers and the court was unwilling to recognize a 'general duty between all participants in market transactions to forego actions based on material non-public information'."[65]

On summary, Chiarella recognized that an insider always has the affirmative disclosure obligation when engaging in purchases or sales of a corporation's stock:

> "This obligation arises because the director, officer or control shareholder is considered a fiduciary who may not personally benefit at the expense of shareholders . . . secondly, there may be an affirmative duty to disclose if there is a special relationship of trust and confidence between buyer and seller. However, Chiarella had no such duty because he had no prior dealings with (the sellers). . . He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence."[66]

(iii) <u>Chief Justice Burger's Dissent - The Misappropriation Theory</u>

As stated previously an important question was left open in the case, namely whether Chiarella's breach of duty to his employer and his employer's customers by using confidential information could be the basis of criminal liability under the Rule. The majority felt the matter had not been properly put to the jury at trial and could therefore not be considered. Chief Justice Burger in dissent felt the issue had been properly before the jury and would have upheld Chiarella's conviction on the "misappropriation" theory. Under this view the conversion by an outsider of nonpublic information and the use of that misappropriated information was sufficient to establish fraud in connection with the purchase of securities.

> "Under the misappropriation theory one who converts nonpublic information entrusted to him in confidence has a duty not to exploit 'his ill-gotten informational advantage by purchasing securities in the market'."[67]

Burger based his theory on the <u>Cady, Roberts</u> access test and he " believed that both factors are satisfied whenever a party obtains an informational advantage by unlawful means."[68] Justices Blackmun and Marshall agreed with Burger's misappropriation theory.

(iv) The Law After Chiarella: Insider Trading

Donald Langevoort reflected on the law as it stood after Chiarella in the following passage:

> "The holding of the Chiarella case is narrow: a rejection, as a matter of statutory contruction of the idea that mere possession of material, non-public information gives rise to a duty to abstain or disclose. While the Court emphasized the 'pre-existing duty' matter arising from the fiduciary relationship of trust and confidence as the basis of the affirmative disclosure obligation its opinion need not have meant that this was the exclusive source of duty."[69]

Langevoort notes that this is indicated in the majority's reservation for another case of the "misappropriation" theory discussed by Chief Justice Burger. But it is Langevoort's view that the Court's analysis created a 'framework' that will serve as a source of authority for future insider trading cases. Langevoort states that the case reflected the Courts "dissatisfaction with the federal statute and rule . . . that provides no clear indication of what securities-related activity is prohibited."[70]

> "The opinion is a study in line-drawing, arbitrary if need be, and the lower courts and the SEC have acknowledged the significance of those lines in subsequent decisions. Most important, a duty to disclose - something more than an ad hoc conclusion that fairness requires disclosure in a particular case - will have to be identified before liability can be imposed."[71]

(c) DIRKS V. SEC (U.S.S.C. 1983) [72]

Within a relatively short time the Supreme Court found itself with another opportunity for some judicial line-drawing on the extent of liability under Rule 10b-5.

Dirks was an officer of a registered broker-dealer that dealt primarily with institutional investors. Dirks was an analyst who specialized in providing investment analysis of insurance company securities to institutional investors. Dirks received information from a former officer of an insurance company that its assets were vastly overstated as the result of fraudulent corporate practices and that various regulatory agencies had failed to act on similar charges made by company employees.

Upon Dirks' investigation of the allegations, certain company employees corroborated the fraud charges, but senior management denied any wrong-doing. Neither Dirks nor his firm owned or traded any of the company's stock but throughout his investigation he openly discussed the information he had obtained with a number of clients and investors, some of whom sold their holdings in the Company.

The Wall Street Journal declined to publish a story on the fraud allegations as urged by Dirks. After the price of the insurance stock fell, the New York Stock Exchange halted trading in the stock.

State insurance authorities then impounded the company's records and uncovered evidence of fraud. Only then did the SEC file a complaint against the Company. After a hearing concerning Dirks' role in the exposure of the fraud, the SEC found he had aided and abetted violations of the anti-fraud provisions, by repeating allegations of fraud to members of the investment community who later sold their stock in the insurance company. Because of Dirks' role in bringing the fraud to light, the SEC only censured him.[73] On review, the Court of Appeals entered judgment against Dirks. Dirks argued before the D.C. Circuit Court of Appeals that neither he nor his informants had a duty to keep their information confidential with respect to the fraud. Absent such a duty, they were free, within the holding of Chiarella, to trade without disclosing.

Judge Wright disagreed and held that Rule 10b-5 may require a fiduciary to disclose material information acquired as a fiduciary before trading or tipping, even if it would not be a breach of their fiduciary duty to disclose the information. Wright held that Dirks' conduct fell within the holding as to tippees in Shapiro[74] and further held Dirks liable on a separate ground.

> "As a registrant, he held that Dirks was subject to 'myriad duties' not imposed on insiders or member of the public. Although a 'high standard of ethical behaviour had traditionally been imposed on brokers in their dealings with customers, it was also applicable in their dealings with the SEC and the public at large'."[75]

However the Supreme Court exonerated Dirks of any wrongdoing, and that Court reiterated the narrower, fiduciary theory of liabilty. Justice Powell cited Cady, Roberts, Smith's opinion in Investors Management, and Chiarella. The Court held that the principle of market fairness is not sufficient to create an affirmative disclosure obligation and citing Chiarella, Powell held that possession of non-public information does not give rise to a duty to disclose or abstain; only a specific relationship does that:

> "We were explicit in Chiarella in saying that there can be no duty to disclose where the person who has traded on inside information 'was not (the corporation's) agent, . . . was not a fiduciary, (or) was not a person in whom the sellers (of securities) had placed their trust and confidence. Not to require such a fiduciary relationship . . . would depart radically from the established doctrine that arises from a specific relationship between two parties' and would amount to 'recognizing a general duty between all participants in market transactions to forego actions based on material, non-public information."[76]

(i) Supreme Court's View of Who is Subject to Rule 10b-5 with regard to Tippees:

Justice Powell noted that this requirement of specific relationship between the shareholders and the individual trading on inside information has created "analytical differences" for the SEC and the Courts on policing tippees who trade on inside information. Unlike insiders who have independent fiduciary duties to both the corporation and the shareholder, the typical tippee has no such relationships. Powell notes that because of this it has been unclear how a tippee inherits the Cady, Roberts duty to refrain from trading on inside information. Reviewing the SEC position, Powell states that their view is that a tippee "inherits" the Cady, Roberts obligation to shareholders whenever he receives inside information from an insider.[77]

> "In effect, the SEC's theory of tippee liability in both cases (Chiarella and Dirks) appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in Chiarella that only some persons, under some circumstances, will be

> barred from trading while in possession of material, non-public information. Judge Wright correctly read our opinion in Chiarella as repudiating any notion that all traders must enjoy equal information, before trading. The 'information' theory is rejected. Because the disclose-or-refrain duty is extraordinary, it attaches only where a party has legal obligations other than a mere duty to comply with the general anti-fraud proscriptions in the federal securities laws."[78]

Justice Powell stated that the Court reaffirmed that a duty to disclose arises from a relationship between the parties and not just from one's ability to acquire information because of his position in the market. The Justice criticized the SEC for over-reaching its authority in its quest for "equal information and fairness".

(ii) Supreme Court's View of Analysts

The Court held that imposing a duty to disclose or abstain solely because a person knowingly receives material, non-public information from an insider and trades on it, could have an "inhibiting influence on market analysts" which the "SEC itself recognizes is necessary to the preservation of a healthy market."[79]

The Court recognized in footnote seventeen[80] that market efficiency in pricing is "significantly enhanced by (their) initiatives to ferret out and analyze information, and thus the analysts' work redounds to the benefit of all investors". The court states in this same footnote that the rule is "inherently imprecise" and "imprecision prevents parties from ordering their actions in accord with legal requirements".

> "Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed."[81]

(iii) Question: When will liability attach to a tippee who trades or becomes a tipper?

The Court held that the tippee's liability is derivative from the insider's duty:

> "Thus, 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."[82]

Referring to Commissioner Smith's views in In re Investors Management, the Court held that tippee responsibility must be related back to insider responsibility.

The next step then in determining whether a tippee is under an obligation to disclose or abstain is to determine whether the insider's 'tip' constituted a breach of the insider's fiduciary duty. Whether the disclosure is a breach of the duty depends in large part on the purpose of the disclosure.[83]

> "This standard was identified by the SEC itself in Cady, Roberts: a purpose of the securities laws was to eliminate 'use of insiders information for personal advantage' . . . thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."[84]

Justice Powell states that this analysis requires the court to focus on objective criteria, i.e. whether the insider receives a direct or indirect personal benefit from the disclosure, such as " pecuniary gain" or "reputational benefit that will translate into future earnings."

(iv) Significance of the Supreme Court Decision in Dirks

Justice Powell stated that "it is essential, we think, to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's insider-trading rules, and we believe that there must be a breach of the insider's fiduciary duty before the tippee inherits the duty to disclose or abstain".[85] In contrast, the Justice stated, the rule adopted by the SEC would have "no limiting principle".[86] The great significance of the Dirks decision lies in the guidance it provided to the founding of liability under Rule 10b-5 and in particular the liability of tippees.

In addition to the traditional insider, Dirks in footnote fourteen recognized another class of persons who have the same affirmative duty to disclose as traditional insiders. These are "temporary insiders" and they will be discussed subsequently. The SEC's General Counsel has commented that footnote fourteen of Dirks gives the Commission a " valuable new tool"[87] through the Court's theory of constructive insider.

Despite the Court's reaffirmation of the traditional fiduciary principles set out in Chiarella, Wilkinson has stated that there is still ample scope for a finding of liability:

> "The only persons who escape an affirmative duty to disclose are the tipper with a clean heart and his tippee (unless he can be construed to be a quasi-insider) such as a cab driver or football coach who overhears an insider and trades thereafter."[88]

(d) RESPONSE OF THE SEC TO CHIARELLA: RULE 14e-3

The SEC responded to what it viewed as the restrictions imposed on regulating insider trading by Chiarella, by the adoption of Rule 14e-3.[89] This rule makes it unlawful, once substantial steps to commence a tender offer have been taken, for any person to trade in securities of the target while in possession of material information relating to the tender offer with knowledge or reason to know that such information is nonpublic and was acquired from insiders of the offeror or target.[90]

> "Rule 14e-3 thus imposes a duty to abstain from trading solely on the basis of knowing possession of material, non-public information relating to tender offers. A fiduciary duty or other confidential relationship to the other party to a transaction is not an element of the Rule 14e-3 requirement to refrain from trading."[91]

Rule 14e-3 thus, in essence, resurrects the possession test rejected by the Supreme Court in Dirks and Chiarella and these decisions therefore raise a significant question as to the rule's validity.[92] The SEC's strategy in issuing its new ruling was to circumvent the Chiarella ruling. Despite the questionable authority of the SEC to issue Rule 14e-3 following Chiarella, most lower courts, both before and after Dirks, have seemed willing to sustain and apply the rule.[93]

(e) EFFECTS ON FINANCIAL ANALYSTS FEDERATION AND THE INSTITUTE OF CHARTERED FINANCIAL ANALYSTS

Standard of Practice Handbook

Standard IIC (Prohibition Against Use of Material Non-Public Information)

In April of 1984 (the Dirks decision was in July, 1983) the Financial Analysts Federation and the Institute of Chartered Financial Analysts met and the Joint Board of Trustees aproved a recommendation from the Professional Ethics Committee to change Standard IIC of their Standards of Practice Handbook in view of the Supreme Court decision in Dirks. Standard IIC was amended to read as follows:

> The financial analyst shall comply with all laws and regulations relating to the use of material non-public information.
>
> (1) If the analyst acquires such information as a result of a special or confidential relationship with the issuer, he shall not communicate the information (other than within the relationship), or take investment action on the basis of such information if it violates that relationship.
>
> (2) If the analyst is not in a special or confidential relationship with the issuer, he shall not communicate or act on material non-public information if he knows or should have known that such information was disclosed to him in breach of a duty. If such a breach exists, the analyst shall make public dissemination of such information."[94]

The change is the addition of: "If he knows or should have known that such information was disclosed to him in breach of a duty" - the exact wording of Justice Powell in Dirks in outlining tippee liability.

(f) CONCLUSION

Through case law developed by the courts and the SEC, various theories of liability for insider trading have evolved. A recent commentary has conveniently categorized the case law into three distinct phases for analysis, namely a first phase involving the application of fiduciary duty standard, a second phase involving the possession theory and a third phase involving a return to the fiduciary duty standard.[95]

The early decisions under Rule 10b-5 based insider trading liability on the concept of the fiduciary duty of corporate insiders not to favour their own interests over those of the corporation or its shareholders. The Courts therefore held that insiders owed a duty of trust to refrain from trading in their corporation's securities on the basis of material, non-public information gained from their relationship to that corporation unless that information is available to those with whom they trade. This is the corporate fiduciary theory of liability. The cases of Kardon and Speed are illustrative of this theory.

In the second phase of case law development, the "possession theory" was developed to provide the rationale for the extension of insider trading liability beyond the bounds of the corporate fiduciary theory:

> "The Courts and the SEC were able to encompass a wide range of conduct within the scope of the Rule 10b-5 insider trading doctrine only by changing the doctrine's theoretical underpinnings. They did so by expanding the basis for liability from the relatively narrow fiduciary duty owed by insiders to their corporation and its shareholders to a broader theory based on the mere possession of material, non-public information."[96]

The development of this trend began with the SEC's administrative decision in Cady, Roberts as discussed. The SEC held that the obligation to disclose-or-abstain was not limited to traditional insiders because of the inherent unfairness involved where a party takes advantage of inside information knowing that it is unavailable to those with whom he is dealing. Using a two-pronged test of "access" and "fairness" the SEC extended liability in trading on insider information to a tippee who did not have the traditional fiduciary relationship to those with whom he traded. This test became the "access test". The theory as with the other theories will be examined in greater detail in subsequent chapters but briefly in this theory, liability is based on the existence of a relationship giving access to information intended to be available only for a corporate purpose and secondly the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Texas Gulf Sulphur picked up the "inherent unfairness" principle of Cady and extended liability beyond the fiduciary duty test to any person in possession of material, non-public information. The Court pronounced the "possession" test, that is that anyone in possession of material inside information must either disclose it to the public or if he is unable to disclose it, he must abstain from trading in the securities which such inside information remains undisclosed. The theory will be examined in more detail in subsequent chapters but it is important to note that the court "shifted the policy objective of the insider trading doctrine under Rule 10b-5 from the prevention of insider misconduct to the promotion of equal access to equal information by all investors."[97] This has been termed the equal information theory.

The third phase of case law development involves a return "full circle"[98] to the fiduciary duty standard. In Chiarella as discussed, the Court rejected the equal information theory in favour of a breach of fiduciary duty analysis. The Court rejected the position that general notions of market fairness and equality of information were sufficient to create an affirmative duty to disclose. Rather the Court held that liability must be founded on a duty to disclose non-public information that arises from a relationship of trust between the parties, that is, the corporate fiduciary theory. Dirks confirmed the corporate fiduciary rationale of Chiarella. Again, this theory will be examined in more detail in subsequent chapters. Dirks also provided guidance to the circumstances in which tippees are liable under Rule 10b-5 for trading on inside information. As discussed, the Court held that a tippee's duty to disclose or abstain is derivative from the insider's duty.

Importantly, the Dirks case is significant as well for broadening the definition of insider by creating a class of constructive or temporary insiders in footnote fourteen. The Court observed that unlike insiders, the typical tippee has no fiduciary duty to the tipper's company or its shareholders. Nevertheless, the Court stated that in certain circumstances such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders become fiduciaries of the shareholder:

> "The opinion emphasized that this constructive insider theory is fully consistent with the fiduciary duty test because such persons 'have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes'."[99]

For such a duty to arise, the corporation must expect the outsider to keep the disclosed non-public information confidential.[100]

Lastly, as discussed previously, a further theory has evolved from Chief Justice Burger's dissenting opinion in Chiarella. This is the "misappropriation theory". Under this theory of liability, the outsider's conversion of non-public information and the use of that misappropriated information is sufficient to establish fraud in connection with the purchase of securities. One who converts non-public information entrusted to him in confidence has a duty not to exploit his informational advantage by purchasing securities in the market. The insider trading case law in the period following Dirks evidences the application of the misappropriation theory as will be discussed below.

CHAPTER III

FOOTNOTES

1. H.T. Wilkinson, "The Affirmative Duty to Disclose After Chiarella and Dirks" (1985) 10 J. Corp. L. 581 at 583.

2. 13 S.E.C. 373 (1943).

3. Wilkinson, supra, note 1 at 583, 584.

4. 13 S.E.C. at 373, 374.

5. Ibid. at 381.

6. 73 F. Supp. 798 (E.D. Pa. 1947).

7. Wilkinson, supra, note 1 at 584.

8. 73 F. Supp. at 802.

9. Ibid. at 803.

10. Wilkinson, supra, note 1 at 584.

11. 99 F. Supp. 808 (D. Del. 1951).

12. Ibid. at 828, 829.

13. Ibid. at 829.

14. Wilkinson, supra, note 1 at 584.

15. Ibid. at 585.

16. 40 S.E.C. 907 (1961).

17. Chiarella v. United States, 100 S. Ct. 1108 (1980); Dirks v. S.E.C., 103 S. Ct. 3255 (1983).

17A. 40 S.E.C. at 911.

18. Ibid. at 912.

19. Ibid.

20. Wilkinson, supra, note 1 at 585.

21. Ibid. at 586.

22. Ibid.

23. 401 F. 2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

24. Wilkinson, supra, note 1 at 586.

25. Ibid.

26. 401 F. 2d at 848.

27. D.C. Langevoort, "Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement" (1982) 70 Cal. L. Rev. 1 at 9.

28. H.S. Bloomenthal, Securities Law Handbook, (New York: Clark Boardman Co., Ltd., 1985) at 334.

29. Ibid. at 335.

30. 495 F. 2d 228 (2d, Cir. 1974).

31. 542 F. 2d 307 (6th Cir. 1976), cert. denied 98 S. Ct. 649 (1977).

32. Bloomenthal, supra, note 28 at 335.

33. 44 S.E.C. 633 (1971).

34. Ibid. at 633, 634.

35. Wilkinson, supra, note 1 at 587.

36. 44 S.E.C. at 644.

37. Wilkinson, supra, note 1 at 587.

38. 44 S.E.C. at 648.

39. Ibid. at 651.

40. Shapiro, supra, note 30.

41. Wilkinson, supra, note 1 at 588.

42. Langevoort, supra, note 27 at 10.

43. Ibid.

44. Ibid.

45. 565 F. 2d 8 (2d Cir. 1977).

46. Ibid. at 9.

47. Ibid. at 10.

48. Ibid.

49. _Ibid._ at 17.

50. _Ernst & Ernst v. Hochfelder,_ 425 U.S. 195, 96 S. Ct. 1375 (1976).

51. 565 f. 2d at 14.

52. 100 S. Ct. 1108 (1980).

53. Langevoort, _supra,_ note 27 at 3.

54. 100 S. Ct. at 1112.

55. 588 F. 2d 1358 (2d Cir. 1978).

56. Langevoort, _supra,_ note 27 at 3.

57. _Ibid._ at 12.

58. 100 S. Ct. at 1113.

59. _Ibid._

60. Langevoort, _supra,_ note 27 at 12.

61. 100 S. Ct. at 1114.

62. _Ibid._

63. Wilkinson, _supra,_ note 1 at 590.

64. 100 S. Ct. at 1118.

65. S.M. Beck, "Of Secretaries, Analysts and Printers: Some Reflections on Insider Trading" (1983-84) 8 Can. Bus. L. J. 385 at 389.

66. Wilkinson, _supra,_ note 1 at 590.

67. _Ibid._ at 591.

68. _Ibid._

69. Langevoort, _supra,_ note 27 at 16.

70. _Ibid._

71. _Ibid._ at 17.

72. 103 S. Ct. 3255 (1983).

73. _Ibid._ at 3256, 3257.

74. 495 F. 2d 228.

75. Beck, _supra,_ note 65 at 391.

76. 103 S. Ct. 3261.

77. _Ibid._ at 3262.

78. _Ibid._ at 3263.

79. _Ibid._

80. _Ibid._

81. _Ibid._

82. _Ibid._ at 3264.

83. _Ibid._ at 3265.

84. _Ibid._

85. _Ibid._ at 3266.

86. _Ibid._

87. Beck, _supra,_ note 65 at 393.

88. Wilkinson, _supra,_ note 1 at 594.

89. 17 C.F.R. para. 240 14e-3 (1984).

90. R.M. Phillips and R.J. Zutz, "The Insider Trading Doctrine: A Need For Legislative Repair" (1984) 13 Hofstra L. Rev. 65 at 95.

91. _Ibid._

92. _Ibid._

93. R.A. Prentice, "The Impact of _Dirks_ on Outsider Trading" (1985) 13 Sec. Reg. L. J. 38 at 44.

94. _C.F.A. Professional Responsibilities,_ (Charlottesville: The Institute of Chartered Financial Analysts, Revised July 1984) at 7.

95. Phillips, _supra,_ note 90 at 73.

96. _Ibid._ at 74.

97. _Ibid._ at 76.

98. _Ibid._ at 73.

99. _Ibid._ at 82, 83.

100. _Ibid._ at 83.

CHAPTER IV

CASE LAW DEVELOPMENT SINCE CHIARELLA AND DIRKS

(a) INTRODUCTION

In Chiarella and Dirks the Supreme Court answered in the negative the question whether liability for trading on the basis of inside information was grounded on the concept of relative informational advantage. However, two issues remained alive. One question left open was whether a person misappropriating and trading on the basis of inside information violated Rule 10b-5.

In Chiarella the majority did not consider the issue, asserting it had not been properly put before the jury.[1] Justice Stevens in a concurring judgment considered the theory viable, but expressed no opinion either way.[2] Chief Justice Burger in dissent felt the issue had been properly before the jury, and concluded that Chiarella "working literally in the printshop misappropriated -- stole to put it bluntly -- valuable non-public information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates ss.10 (b) and Rule 10b-5."[3]

The second issue arose from the Court's affirmation in Dirks in a celebrated footnote (number fourteen) to its decisions, that in certain circumstances persons normally considered outsiders in relation to duties owed to relevant shareholders may become their fiduciaries and hence insiders of those shareholders. Consequently, liability for trading on non-public inside information so received would attach.

> "14. Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation,

these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. See SEC v. Monarch Funds, 608 F.2d 938, 942 (CA2 1979); In re Investors Management Co., 44 S.E.C. 633, 645 (1971); In re Van Alstyne, Noel & Co., 43 S.E.C. 1080, 1084-1085 (1969); In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 937, (1968); Cady, Roberts, 40 S.E.C., at 912. When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (CA2 1974) (investment banker had access to material information when working on a proposed public offering for the corporation). For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty." (103 S. Ct. 3255, 3262 (1983)).

This recognition of "constructive" insiders has been affirmed and applied in the lower Courts after Dirks. As will be reviewed below, the concept has been expanded to render such parties "temporary" insiders.

(b) INSIDER TRADING AND MISAPPROPRIATION OF INFORMATION

(i) U.S. v. Newman (2d Cir. 1981)

The misappropriation theory of liability had its most significant exposition in the Newman case.[4] The United States Court of Appeals, Second Circuit, on facts analogous to those in Chiarella, held that a criminal violation of Rule 10b-5 may be established by an agent breaching his duty to respect client confidences.[5]

In an enforcement proceeding, Newman, a securities trader and manager of over-the-counter trading department of a New York brokerage firm, Antoniu and Courtois, employees of two prominent Wall Street investment banking companies, Morgan Stanley & Co., and Kuhn Loeb & Co., and two other parties were indicted by the government. It was alleged that between 1973 and 1978 Antoniu and Courtois misappropriated confidential nonpublic information regarding proposed mergers and acquisitions from their respective employers. Further, it was alleged that they surreptitiously conveyed this information to Newman who in turn passed it to the other two parties, both of whom resided and operated abroad.

Using secret foreign bank and trust accounts, Newman and the others purchased stock in companies that were merger and takeover targets of the clients of Morgan Stanley and Kuhn Loeb. Substantial gains were made when the takeover plans were announced publicly with a consequent rise in the stocks' market price.[6]

As in Chiarella the indictment alleged that the defendants' conduct in misappropriating and trading on confidential information constituted criminal violations of s. 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereof. However, the Department of Justice did not allege the gravamen of the offence to be a failure to disclose, but rather to be a fraud committed through Antoniu's and Courtois' breach of fiduciary duties owed to their employers, their employers' corporate clients, and the clients' shareholders.[7] Newman was charged with aiding these two defendants in violating those fiduciary duties.[8]

At the District Court level Newman's application to dismiss all relevant counts succeeded. The Court decided there was no clear indication in law that Rule 10b-5 extended to the non-insider violations of a fiduciary duty owed to an acquiring corporation in a tender offer.[9] On Appeal, the Second Circuit reversed, expressly adopting the misappropriation theory left open by the Supreme Court in Chiarella.

The Second Circuit Court found that a violation of an employee's duty to respect client confidences gave rise to a Rule 10b-5 violation when the employee traded on the converted information.[10]

The Court established three important tenets integral to its conclusion:

(a) in criminal or injunctive proceedings the fraud need not be perpetrated upon the actual buyer or seller of securities to impose Rule 10b-5 liability (this arises only in relation to a standing requirement where an implied private right of action for damages under Rule 10b-5 arises),[11]

(b) the fraud or deceit requirement of the Rule was clearly founded upon the defendants' misappropriation of confidential information, a fraud upon their employers and the employers' clients,[12]

(c) the "in connection with" (the purchase or sale of any security) limitation in Rule 10b-5 is subject to flexible construction; deceptive practices "touching" the sale of securities are enough. In Newman the sole purpose of the scheme was to purchase target companies' shares, and this nexus satisfied the Rule 10b-5 requirement.[13]

Of note is the Court's characterization of the fraud by the employees of Morgan Stanley and Kuhn Loeb:

> "By sullying the reputations of Courtois' and Antoniu's employers as safe repositories of client confidences, appellee and his cohorts defrauded those employers as surely as if they took their money."[14]

One commentator has noted that the Court "effectively added a new weapon to the SEC's antifraud arsenal, thereby enabling it to police insider activities which otherwise would be unreachable under Chiarella."[15] As well, the public opprobrium of criminal sanction was thought to instill greater vigilance in the employers' protection of confidential information; nor would the deterrent aspect be lost upon would-be perpetrators. Finally, and perhaps most importantly, the court's rigorous enforcement in Newman was seen as an assurance to the investing public that the wide incidence of insider trading suspected was to be checked.[16]

The same commentator expressed concern that in Newman the Court was in effect imposing liability on outsiders on the theory of a " fraud on the source" of the information, labelling this as not a mere definition of, but rather an expansion of the scope of Rule 10b-5. This was thought not to be in tune with the philosophy of the Supreme Court as expressed in Chiarella.[17] However, the majority of the Supreme Court in Chiarella left open the question of whether the defendant was criminally liable for his breach of duty owed his employer and his employer's clients, as that issue was not properly before the jury at trial. Chief Justice Burger in strong dissent would have found Chiarella liable on the "misappropriation theory". Therefore, the development of that theory in Newman, it is submitted, does not conflict with, but is complementary to the remedy developed in Chiarella.

Despite the initial misgivings of some commentators, it was apparent that Newman's analysis was to take hold not only in a number of lower Court decisions (to be reviewed below) but more recently in the Supreme Court itself.

(ii) . Bateman Eichler, Hill Richards Inc. v. Berner (USSC 1985)

In this case recently decided by the U.S. Supreme Court,[18] investors filed suit under federal securities laws alleging they incurred substanial losses as a result of a conspiracy between one Lazarro, a registered securities broker employed by Bateman Eichler, and one Neaudeau, president of a corporation, to induce them to purchase large amounts of that corporation's stock. The inducement was the divulging of false and materially incomplete information about the company's ventures (regarding an illusory gold strike in Surinam) on the pretext that it was accurate, inside information.[19]

The Supreme Court, affirming the Court of Appeals, Ninth Circuit, held that the alleged defence of "in pari delicto" (equal fault) did not apply to bar a private damages action of the "tippees" in those circumstances. In resolving that particular issue the Court balanced the rights of the defrauders and the defrauded, with the need to protect the investing public and the national economy. In doing so, it determined that while the defrauded "tippees" may have some culpability in participating in the defrauders' "tipping" scheme, it did not amount to the "substantially equal responsibility" required to bar their action. Of significance was the Court's holding that to preclude the suit would significantly interfere with effective securities laws enforcement, and protection of the investing public.[20]

More significantly for our purposes, the court went on to consider the alleged violation of ss. 10(b) and Rule 10b-5. While accepting the District Court and Court of Appeals assumptions of that liability, the Court reviewed its decision in Chiarella and Dirks. Without expanding the principles of those cases the Court affirmed the requirement of a breach of the tipper's fiduciary duty, and the requirement of a personal benefit derived therefrom, before the tippee may be liable.[21]

However, the Court also noted and gave approval to its view in Dirks that alternatively "a tippee may be liable if he otherwise " misappropriate(s) or illegally obtain(s) the information" " and proceeds to trade upon or communicate it.[22] It is submitted that the Second Circuit Court's application of the misappropriation theory in Newman is compatible with, and supported by the Supreme Court's reaffirmation of liability through misappropriation.

Of pertinent value has been recent commentary by the SEC on this and other cases decided after Chiarella and Dirks in a Report to the Congressional House Commerce Committee in August of 1985.[23] In ordering the annual Reports the Committee expressed its concerns that Dirks might have adversely affected the SEC's successful prosecution of insider trading cases. The Report indicates clearly that despite these initial concerns, the SEC's enforcement programme has not been unduly hindered by the decision. This is in large measure due to the SEC's pursuit of the alternative grounds for liability, that is, of misappropriation and "constructive" insider concepts, alternatives approved by the Supreme Court. To quote the SEC itself on this most recent development,

> "By, in effect, endorsing prevailing judicial interpretation of Dirks, the court's opinion in Bateman Eichler should foreclose a number of the arguments made in the past by defense counsel in Commission Enforcement cases and make it unlikely that future court decisions will interpret Dirks to narrow, to any significant degree, the scope of insider trading prohibitions."[24]

(iii) SEC v. Materia et al. (S.D.N.Y. 1983)

The facts of this case were in effect Chiarella revisited.[25] Materia was an employee of a financial printing firm, Bowne of New York City, Inc. (Bowne). Bowne printed inter alia proposed tender offers for use by its corporate clients. As even the hint of an upcoming offer could send the target company's stocks price soaring, sensitive information identifying these targets was blacked out, to be filled in on the eve of publication. As a "copyholder" at Bowne, who assisted in the proofreading of such drafts, Materia was able to divine the identities of at least four tender offer targets between December 1980, and September 1982. In each case he purchased stock of the target company within hours of discovering its identity, and within days -- after the offer had been made public -- would sell his holdings at substantial gains.[26]

The SEC filed an enforcement action alleging violation of inter alia s. 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.[27] Significantly, the complaint alleged that Materia had misappropriated material nonpublic information from his employers and its clients.

At the District Court level, the Court found Materia had, in fact, stolen confidential data from Bowne, which he traded to his benefit. In doing so, he had breached a fiduciary duty at common law owed his employer, rather than upon any duty to selling shareholders. Chiarella and Dirks were thus distinguishable.[28]

However, the Court's finding "indicates an adherence to the principle of Chiarella and Dirks -- namely, that one with access to nonpublic corporate information cannot use such information to make secret profits."[29]

By adhering to that principle, the Court affirms and indeed clarifies that application and consequent effect of the Chiarella and Dirks opinions, but in founding liability upon the misappropriation theory in cases such as Materia disciplines those who might otherwise be exempt from control.

The Second Circuit affirmed the District Court in Materia, citing Newman with approval. In giving further justification for the use of the misappropriation theory of liability, and in answer to Materia's claim that Bowne suffered no harm as a result of his misappropriation of client information, the Court asserted:

"Among a financial printer's most valuable assets is its reputation as a safe repository for client secrets. By purloining and trading on confidences entrusted to Bowne, it can not be gainsaid that Materia undermined his employer's integrity . . . we are driven to the conclusion that, . . . Materia perpetrated a fraud upon Bowne."[30]

In noting that the Supreme Court in Chiarella "did not disavow" the question of liability through misappropriation, the Second Circuit affirmed that theory's compatibility with Chiarella and with Dirks as well. The Court in its final words gave forcefully its view of the law's intent:

". . . the question of Anthony Materia's liability was settled fifty years ago. Determined to combat fraud in the securities market place Congress chose to enact a comprehensive yet open-ended statutory scheme, capable of ongoing adaptation and refinement . . . We do not believe the drafters of the Securities Exchange Act of 1934 -- envisaging as they did an open and honest market -- would have countenanced the activities engaged in by Anthony Materia."[31]

Nor, would one equally submit, the activities of Vincent Chiarella. Materia is seen by the SEC as a key decision, calling the Second Circuit's opinion "perhaps the single most important opinion in insider trading since the Dirks decision."[32] The SEC noted the Second Circuit's view that the misappropriation theory was not inconsistent with Dirks, and further the important extension of the theory to found liability in the SEC's civil enforcement cases.[33]

(iv) SEC v. Musella et al. (S.D.N.Y. 1984)[34]

Newman was again applied in this case, providing the basis for granting a preliminary injunction against one Ihne, office manager of a large New York law firm, Sullivan & Cromwell (Sullivan). Ihne, privy to nonpublic confidential information through his employment regarding company clients of his firm, tipped information regarding tender offers planned by those clients to several persons (including the named defendant Musella). These other persons traded on the information, as did Ihne. The securities traded were those of the target companies.

The Court noted that on the principle of Chiarella, Ihne as a tipper must be found to owe, and have breached, a fiduciary duty to the shareholders and corporations whose securities were traded. The Court could not found such a duty on the facts.[35]

However, it acceded to the SEC's submission that Ihne owed a fiduciary "duty of silence" to the Sullivan firm and its corporate clients. Referring inter alia to Newman and the District Court in Materia (the Appeal was yet to have been decided), the Court concluded that,

> ". . . the general principle emerges that Rule 10b-5 liability may be imposed on those who trade on the basis of material non-public information tainted by the breach of an insider's fiduciary duty, regardless of whether that duty runs to the sellers of the securities involved. By endorsing the alternative "misappropriation" theory of Rule 10b-5 Newman . . . the Second Circuit gave legal effect to the common sensical view that trading on the basis of improperly obtained information is fundamentally unfair, and that distinctions premised on the source of the information undermine the prophylactic intent of the securities laws."[36]

Of note was the Court's consideration as well that under footnote fourteen of Dirks (liability as a constructive insider) Ihne might well have been thus categorized.[37]

(v) SEC v. Switzer (W.D. Okla. 1984)[38]

In the judicial decisions rendered since Dirks, this case is the only one the SEC has lost. It was lost plainly on its particular and peculiar fact pattern which it is submitted defines the outer boundaries of insider trading liability.

Briefly, Switzer was a well-known sports personality in Oklahoma, with various financial interests in the oil and gas industry. He allegedly overheard at a track meet one Mr. Platt, a corporate insider of Phoenix corporation, tell Platt's spouse of a proposal to liquidate the said corporation. This was heard days before the public announcement was made. This was clearly inside nonpublic information, and was found by the Court to be "material", i.e. that it would likely affect the investment decision of a reasonably prudent investor. On the basis of the overheard information, Switzer and others to whom he gave the information, purchased Phoenix shares prior to the public announcement, and profited by selling them thereafter.[39]

Significantly, Platt had no share in the profits made by the defendant and his associates, nor were any of them insiders aside from Platt. Switzer and associates were never employees of Phoenix, nor did they have any relationship of trust of confidence with it.[40]

The Court considered Dirks applicable to the facts of the case, giving it straight-forward application, without judically narrowing nor broadening the Dirks principles. Noting that any duty which Switzer could found to have breached must derive from Platt as an insider of Phoenix, the Court concluded that Platt's discussion of possible liquidation of Phoenix by a certain date, to his spouse, was made only to allow her to arrange her home time schedule. Thus Platt was found not to have breached any fiduciary duty he owed to Phoenix. As Platt breached no such duty, Switzer could not acquire nor be liable upon a similar derivative duty. Any information passed by him onto his associates was therefore not in violation of Rule 10b-5. Further, the Court found the even if under Dirks Platt had breached his fiduciary duty by talking aloud about the company's inside affairs (which, it is submitted seems to be the more reasonable conclusion to draw), it could not be found that either Switzer nor his associates knew or had reason to know the information received was material, nonpublic information disseminated by a corporate insider for an improper purpose.[41]

It is to be noted that the SEC has commented in its Report to Congress that the Court in Switzer made its findings on the basis that the SEC had failed to prove the elements of its case. The principles of Dirks remained unchanged.[42]

(vi) U.S. v. Reed (S.D.N.Y. 1985)

This case, a criminal prosecution, alleged that the defendant received from his father, a director of Amax Inc., material, nonpublic information regarding a potential merger between Amax and another company, Socal. This information was expected by the father to be kept confidential by his son. The son however traded in Amax call options on the information making a large profit upon announcement of merger negotiations. Father and son were allegea in the Indictment to share an intimate relationship of trust and confidence antedating the alleged disclosures.[43] The allegation thus was that the defendant misappropriated the information from his father, an insider.

The District Court extensively reviewed the case law on misappropriation, including Newman and Materia. It noted that no duty of disclosure to the sellers of the securities is a prerequisite to misappropriation liability, but that there must at least be a duty of fidelity and confidentiality to some person(s) "rooted in a fiduciary relationship of trust or confidence between the misappropriator and the person or entity to whom the duty is owed."[44]

On the defendant's motion to dismiss inter alia that part of the Indictment alleging misappropriation upon breach of this alleged duty between himself and his father, the Court denied the motion. It allowed the indictment to stand, determining that the ultimate question as to whether misappropriation had occurred depended upon the facts supporting this alleged "confidential relationship". The Court noted that such did not depend on an express agreement but could be determined "where the evidence reveals that conclusion to be in accord with the expectations and behaviour of the parties."[45] Thus

> "it remains open to the Government to prove at trial that Reed and his father were bound by an agreement or understanding of confidentiality, express or implied, or that some regular pattern of behaviour by defendant and his father generated on the part of those two men a justifiable expectation of confidentiality and fidelity."[46]

As the SEC in its Report to Congress has noted, the significance of Reed is in its application of the misappropriation theory to information obtained from an insider of a corporation whose shares were traded; nor is the theory limited to cases of strict fiduciary duty. Finally, it was noted that for the first time the Court held that insider trading in options was subject to legal proscription.[47]

(vii) U.S. v. Winans (D.C.N.Y. 1985)

This, again a criminal prosecution, provides valuable comment by the District Court upon the nature and effect of the misappropriation theory, and its consistency with Dirks as regards insider trading liability.[48]

The facts are unusual. The defendant was charged with others with participation in a scheme to trade in securities based on information misappropriated from the Wall Street Journal (WSJ). Winans was employed by the WSJ as a writer of a daily market gossip feature, " Heard on the Street". The column highlighted certain stocks, providing both negative and positive commentary and information thereon, and took a point of view with regard to investing in those stocks. Winans, among others, testified before the Court that the column had an effect on the price of stocks it mentioned. The information allegedly stolen from the WSJ by Winans was the timing, tenor and content of these columns before their publication. Winans conduct regarding the columns was allegedly in breach of a fiduciary duty owed to his employer, Dow Jones & Co., parent company of the WSJ, contrary to inter alia, Rule 10b-5.[49]

Briefly, Winans deliberately arranged with one Brant, a wealthy and well-known broker, to leak the "Heard" columns (their timing, tenor and content) to Brant prior to their publication. Brant would then trade in specified securities armed with the column's information.[50] While the initial attempt at this scheme brought in a loss, the subsequent prior release to Brant of some twenty-seven articles resulted in net profits of almost $690,000, among a number of participants. Subsequent discovery of the scheme brought Winans and others before the New York District Court.[51]

In extensive reasons, the District Court considered the nature and application of the misappropriation theory, upon which the U.S. government based its case. Canvassing the authorities, including Newman and Materia the Court rejected Winan's argument that those cases required a fraud against the employers and employers' clients (tender offerors in those cases). In view of the Winans court, the third parties who were defrauded in Newman and Materia were only incidental to, and not essential elements of the application of the misappropriation theory.[52]

The Court also concluded that the theory did not require that the victim be a buyer or seller of securities.

To the defendant's argument that Dirks was the controlling case (which if applicable would have founded no liability upon Winans, as he was not a temporary insider, owed no duty to the corporations he wrote about, nor was a tippee of any corporate inside information), the Court simply asserted that,

> ". . . the duties that Dirks addressed are not ones under scrutiny in Newman, Materia or here. Dirks simply did not address the misappropriation theory, the Court having found that Dirks did not "misapproporiate or illegally obtain information".[53]

Here, the Court noted that employer/employee fraud was the focus, an entirely different relationship that that at issue in Dirks.[54]

The Court pointedly asserted as well that the misappropriation theory did not resurrect the "parity of information" theory the Supreme court rejected in Chiarella and Dirks. Referring to Professor Brudney's work on the area, the Court defined that theory essentially to aver "that all investors should have relatively equal access to material information in order to preserve the market's integrity."[55] As regards the misappropriation theory of liability, the Court affirmed its consistency with Dirks in that the focus of the theory "is not whether the defendant had an informational advantage that others could not legally obtain, but on how the defendant gained the advantage, which must be fraudulently."[56] This focus upon conduct according to the Court was the essential focus of the Supreme Court's ruling in Dirks. That Court looked to whether the insider personally benefitted from the disclosure, and such conduct if found on the facts would then support a finding of breach of that insider's duty to shareholders.[57]

In all the circumstances of the Winans case, the Court concluded his conduct to be fraudulent upon the WSJ:

> "What made the conduct here a fraud was that Winans knew he was not supposed to leak the timing or contents of his articles or trade on that knowledge. He knew that these columns were likely to affect the price of the stocks to his benefit. This is true even if he had not known of a written policy; he had knowledge of a Wall Street Journal practice, that is, a rule of conduct, which makes this a clear breach of a fiduciary duty."[58]

The harm to WSJ was that the "fraudulent taking and misuse of the confidential information stolen from (it) placed immediately in jeopardy probably its most valuable asset -- its reputation for fairness and integrity."[59]

Winans was thus found guilty of (among other charges) securities fraud by misappropriating material non-public information from the WSJ.[60]

With co-defendants from trial (one Felis, and one Carpenter), Winans appealed to the Appeals Court, Second Circuit.[61] He contended, inter alia, that he could not be held liable for Section 10(b) and Rule 10b-5 violations of the Securities Exchange Act of 1934 because he was not a corporate insider or "quasi-insider" and did not misappropriate material non-public information from such insiders or "quasi-insiders."

The Court rejected Winans' appeal and confirmed that "Section 10(b) and Rule 10b-5 proscribe an employee's unlawful misappropriation from his employer (a financial newspaper) of material non-public information in the form of the newspaper's forthcoming publication schedule, in connection with a scheme to purchase and sell securities to be analyzed or otherwise discussed in future columns in that newspaper . . ."[62]

The Court emphasized the underlying purpose of the securities legislation it was charged with interpreting:

> "The fairness and integrity of conduct within the securities markets is a concern of utmost significance for the proper functioning of our securities laws. In broadly proscribing "deceptive" practices in connection with the purchase or sale of securities pursuant to section 10(b) of the Securities Exchange Act of 1934 Congress left to the courts the difficult task of interpreting legislatively defined but broadly stated principles insofar as they apply in particular cases."[63]

The Court reviewed the arguments Winans and his co-defendants put forward, and confirmed the effectiveness of the misappropriation theory of liability.

> "The core of appellants' argument is that Newman and Materia are inapposite because in those cases the information was misappropriated by employees who owed a duty of confidentiality not only to their employers, but also to their employers' clients, the corporations whose securities were traded. In other words, appellants argue, the misappropriation theory may be applied only where the information is misappropriated by corporate insiders or so-called quasi-insiders, Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983), who owe to the corporation and its shareholders a fiduciary duty of abstention or disclosure. Thus, appellants would have us hold that it was not enough that Winans breached a duty of confidentiality to his employer, the Wall Street Journal, in misappropriating and trading on material nonpublic information; he would have to have breached a duty to the corporations or shareholders thereof whose stock they purchased or sold on the basis of that information.
>
> Appellants read Newman and Materia and interpret the misappropriation theory too narrowly. Notwithstanding the existence of corporate clients of the employers in Newman and Materia, the misappropriation theory more broadly proscribes the conversion of "insiders" or others of material non-public information in connection with the purchase or sale of securities."[64]

Of note are the Court's comments on the effect of Dirks as regards the Court's general development of alternate grounds of liability:

> "Although Dirks disapproved of certain trading by insiders or quasi-insiders who owe a fiduciary duty to investors, courts are not thereby constrained from recognizing other misconduct. To give Dirks such preclusive effect would

suggest that one application of a statute cannot admit of another application not raised in the first case. As the district court correctly stated, "(i)t is not accurate to say that Dirks wrote the book on insider or outsider trading; it wrote one chapter with respect to one type of frauulent trading." 612 F. Supp. at 842. Indeed, the chapter that Dirks wrote derives from prior jurisprudence in which "fine distinctions and rigid classifications" were appropriately foresaken to facilitate the recognition of significant doctrinal reasons, for holding members of particular, even if new, groups liable. See In Re Cady, Roberts & Co., 40 S.E.C. 907,911 (1961) (liability not restricted to "traditional" insiders such as officers, directors and controlling stockholders), cited approvingly in Dirks, 463 U.S. at 653. Given the broad remedial purposes of the securities laws, the Supreme Court has "repeatedly recognized that securities laws combatting fraud should be construed 'not technically and restrictively but flexibly'."[65]

It is apparent that the Second Circuit Appeals Court was concerned to justify its rejection of Winans appeal not only on its own view of the law, but as a view apparently in accord with the intention of the Supreme Court in Dirks not to allow technical defense to win the day. This is an important affirmation of Materia and Newman, and the misappropriation theory.

These then are the major cases that have proceeded from the principles of Chiarella and Dirks, and based upon the Supreme Court's approval of the place in insider trading jurisprudence of the misappropriation theory, it is submitted that the development of that theory in the cases has been complementary to, and consistent with the Supreme Court's view of Rule 10b-5. The position can be no better stated than by a then Staff Attorney with the SEC, H.T. Wilkinson:

"The affirmative duty to disclose under rule 10b-5 is alive and well. Dirks and Chiarella reaffirm that insiders and quasi-insiders have an affirmative duty to disclose when trading in their company's stock. The Supreme Court's recent decisions also reaffirm a concept advanced both in the common law minority rule cases and in early interpretations of 10b-5: the affirmative duty to disclose rests upon fiduciary notions of trust and loyalty which proscribe the use of nonpublic information by an insider and one with access to such information, for personal benefit. In light of this interpretation, the misappropriation theory is consistent with the Supreme Court's reading of 10b-5. The misappropriator also breaches duties of corporate trust and loyalty to his employer when he uses information intended solely for legitimate business purposes to reap secret profits. In light of the Supreme Court's emphasis on Cady, Roberts, with its formulation of the access test, it would not seem to matter from whom the misappropriator receives information. The violation of 10b-5 occurs when one usurps nonpublic corporate information in violation of official duties and then trades in reliance of such information for personal gain."[66]

(c) INSIDER TRADING LIABILITY -- "CONSTRUCTIVE" OR "TEMPORARY" INSIDERS

As has already been noted, the Supreme Court in Dirks posited in a footnote reference (number fourteen), that with respect to its finding of liability upon those in breach of fiduciary duties, that certain persons working in some capacity for a corporation as outsiders, could become fiduciaries of the shareholders -- that is, where those persons have entered into a special confidential relationship in the conduct of the enterprise's business, and have been given access to information of a nonpublic, corporate-purpose character, those persons become "constructive" insiders.[67] It has been pointed out that when this opinion was announced, then General Counsel for the SEC hailed the decision for giving the Commission "a valuable new tool" through the Court's "theory of the constructive insider".[68] This new tool has not appeared as useful to the SEC's enforcement proceedings as the misappropriation theory has, if volume of cases decided is an indicator. However, the Courts have utilized the constructive insider theory, preferring the appellation of "temporary" insider.

(i) SEC v. Lund (C.D. Cal 1983)

The SEC brought this action under Rule 10b-5 against the defendant for purchasing shares in a publicly traded company, P & F Industries (P & F) after receving material nonpublic information regarding P & F entering into a joint-venture with another larger company. This information allegedly came from a long-time friend and business associate, one Horowitz. Horowitz was a P & F insider. Lund, President of a company called Verit, received the information from Horowitz, a Board Member of Verit, who was enquiring as to whether Verit would be interested in providing capital investment for the possible venture. Instead, after hearing of the likely date the venture was to go through, Lund personally bought shares in P & F, subsequently making a large profit when the price rose following public announcement of the joint venture.[69]

In finding Lund liable for his trading in P & F, the Court first determined the information to be material, non-public and that Lund knew that the information from Horowitz was such. The core issue was whether Lund's failure to disclose the information he received or to refrain from trading in P & F stock was a violation of Rule 10b-5. Reviewing the pertinent cases, the Court noted Dirks, and footnote fourteen thereto.[70] The Court concluded from that reference, that such persons so found to be "insiders" could be called "temporary insiders".[71] Assuming the duties of an insider temporarily, by virtue of the special relationship with the corporation, they become liable for trading on the basis of nonpublic information received in that relationship.[72]

The Court in Lund's case concluded that he was a temporary insider of P & F when he traded on the basis of the information concerning the joint venture. Lund and Horowitz were old friends and more importantly old business associates who often exchanged information about their corporation. Horowitz sat on the Board of Verit. It was because of this special relationship that Horowitz told Verit through Lund of the joint venture. The information was made available to Lund solely for corporate purposes. Finally, the two men's relationship was such that there was a clear implication that the information was to be kept confidential. In these circumstances Lund knew or should have known that the information he received was confidential and had been disclosed only for legitimate corporate purposes.[73]

In this case then the alternative ground of liability as a "temporary insider" was established. Thus one who it was possible to allege was a "tippee" without the derivative duty in Dirks could on the facts be characterized a "tipper" and be liable.

(ii) SEC v. Gaspar (S.D.N.Y. 1985)

On the facts of this case, the Court found the defendant liable on the misappropriation theory, for a breach of his duty to his employer. However, the Court also concluded that the defendant could be considered a "temporary" insider of the company he represented on behalf of his employer, who was intending to acquire another target company.

It is the Court's findings as to his "temporary insider" status that are of interest. Gaspar was employed with an investment banking firm, Baird, as inter alia an oil industry analyst; on behalf of Baird he represented DKM, a company interested in acquiring an oil company, Clark. In that capacity, Gaspar received certain information from DKM which he knew to be confidential. Shortly put, Gaspar imparted important information regarding DKM's position on acquiring Clark to a colleague who then traded upon the information.[74] The Court reviewed footnote fourteen of the Dirks decision, and also had Lund to follow as well. The Court found Gaspar to be a "temporary insider" of DKM:

> "Gaspar obtained access to confidential information solely for the corporate purpose of his representation of DKM . . . By revealing . . . the information . . . Gaspar breached his duties of trust, loyalty, and confidentiality which he owed to both Baird and DKM during the relevant time."[75]

As for the personal gain required under the Dirks rule, while Gaspar himself made no monetary gain, the Court held that he gained a reputational benefit from his colleague in the discussions that ensued once the information was given. At the very least, the Court found the disclosure to be a gift within the Dirks case.[76]

(d) RECENT DEVELOPMENTS IN INSIDER TRADING

(i) SEC v. Levine (S.D.N.Y. 1986)

In this recent case the SEC alleged in its complaint filed May 1986 that Levine, an investment banker employed as a mergers and acquisitions specialist, secretly purchased and sold securities of some fifty-four companies over a five-year period. The transactions were arranged through a Bahamian bank account.[77]

As a result of his scheme he allegedly earned an estimated $12.6 million in illicit profits.

This case did not go before the courts. Levine submitted an Offer of Settlement accepted by the SEC, which was confirmed in New York District Court June 5, 1986. Without admitting or denying the SEC allegations, the defendant agreed to the entry in Court of a permanent injunction against future violations of the antifraud provisions. Further, he agreed to repatriate and disgorge all monies on deposit at his Bahamian bank to well over $10 million.

The allegations of the SEC were contained in a civil injunctive action filed in May 1986 in the U.S. District Court for the Southern District of New York. Levine (with his Bahamian broker one Meier and two companies Levine created to further his schemes), was alleged to have violated the anti-fraud provisions of the SEA of 1934, Section 10(b) and 14(e), and Rules 10b-5 and 14e-3 promulgated thereunder.[78]

It was charged that Levine made his enormous profits through the systematic betrayal of client confidences. The Commission alleged Levine came into possession of material non-public information concerning mergers, tender offers, leveraged buy-outs and other extraordinary corporate transactions that would greatly increase the price of the securities involved.[79] Further allegations were that:

> "Levine learned of these impending transactions, in many cases, through his employment as an investment banker whose firm had been retained to represent one of the corporations involved in the subject transactions. The Commission alleges that Levine, in willful disregard of his duty not to trade or communicate the information he received to another who

> would trade, repeatedly placed orders for accounts in the name of Diamond, DH and IGI through the Institution for the purchase of the securities in question before the public announcement of these extraordinary corporate transactions."[80]

As Levine entered into the Offer of Settlement with the SEC, this precluded a direct finding of liability. It is clear that in his position of trust (which included at the time of the investigation his being a Managing Director of Drexel Burnham Lambert Inc.), Levine was liable as the traditional insider to his main employer and its clients, and also "temporary insider" (of footnote fourteen per Dirks) for those companies upon whose confidential information he gained personal profit.

The impact of the SEC's success in bringing Levine's excesses to light is measured mainly by the reaction of large institutional investors on Wall Street of which he was a part. The first senior banker brought up on insider-trading charges and so effectively caught thereby, Levine's deterrent effect on those of like mind, but with less grandiose schemes, may be considerable.

(ii) SEC v. First Boston Corporation (S.D.N.Y. 1986)[81]

In this recent case, one of Wall Street's premier investment banks, First Boston Corporation (hereafter "FBC") admitted that it had turned a $132,000 profit by trading in CIGNA Corporation securities after confidential information entrusted to the firm's corporate-finance advisers leaked to its own stock-trading desk. However, FBC did not admit or deny the allegation of the SEC that it had breached the anti-fraud provisions of the Securities Exchange Act of 1934, but consented to entry of a Final Judgement of Permanent Injunction and Other Relief requiring the disgorgement of the above-mentioned profits.[82]

The facts indicate that FBC's procedures as regarded internal protection of the confidentiality of restricted corporate information from its own trading branch were inadequate.

On January 20, 1986, the Treasurer of CIGNA Corporation (hereafter "CIGNA") contacted a managing director in FBC's Corporate Finance Department and discussed CIGNA's consideration of increasing its property-casualty loss reserves by $1 to $1.5 billion. At that meeting, FBC investment bankers realized that such action could adversely affect CIGNA stock prices. Accordingly, the CIGNA information was properly recognized as sensitive and FBC's legal department added CIGNA to FBC's "restricted list". Under FBC's procedures, that meant, inter alia, that CIGNA's securities were not to be traded on FBC's account.[83]

On the 29 January, 1986, an FBC managing director in the Corporate Finance Department was informed by CIGNA's Chief Financial Officer that the corporation's Board would announce the discussed addition to the loss reserves on 30 January, 1986. Such information was conveyed to FBC in confidence, and in the context of an investment banking relationship between CIGNA and FBC.

The FBC managing director informed one of the firm's research analysts of the impending decision; that analyst in turn told the head equity trader of FBC, who, although in possession of FBC's restricted list, did not review it but instead ordered that a FBC trader sell such CIGNA securities as were owned by FBC in anticipation of a sharp decline in their price. The end result of trading by FBC on CIGNA's securities before the January 30th announcement were the profits of $132,000 noted above.

The disgorgement of those profits, and a $246,000 fine under the Insider Trading Sanctions Act of 1984 were the penalties imposed on First Boston Corporation.[84]

This case illustrates how crucial the maintenance of confidentiality of insider information is within major institutional investment companies. While certainly not in the category of the planned and deliberate violations of Levine, FBC's lack of paying due attention to its own employees' activities regarding trading on confidential information resulted in what was nevertheless a violation of insider trading rules. The maintenance of a strict internal division in such investment institutions between personnel who deal in underwriting and corporate manoeuvres and personnel who sell securities (creating what is termed "the Chinese Wall") was underlined by the FBC incident.

(iii) U.S. v. Solomon et al. (1986)[85]

As yet to be reported, this case involves those members of the financial community employed in "arbitrage" - traffic in bills of exchange or stocks to take advantage of different prices in other markets, which may also include the practice of switching short-term funds from one investment to another to get the best return. On Wall Street, "arbitragers" deal mainly in takeovers to make their profits, and have been described as "sophisticated market players (who) are not traditional "insiders", but their stock in trade is information. They have . . . "sophisticated networks" that often include bankers, lawyers, and executives who are privy to inside informaion."[86]

It is of interest that arbitragers were cultivated by Levine, and that the SEC's invstigations recently resulted in the U.S. government's indictment of two arbitragers, Andrew Solomon of Marcus Schlon & Company, and Robert Salsbury of Drexel Burnham (the latter company Levine's employer). With three other defendants, dubbed the "Yuppie Five", they are alleged to have profited from trading on confidential information stolen from the law firm of one of the defendants, who tipped such information to the arbitragers. That information dealt with expected takeovers, and part of the takeover specialist's armoury includes destabilization of the takeover target by channeling its shares into the hands of arbitragers.[87]

The Solomon case marks the first intrusion by the SEC into this specialized group, which views itself as a tip-oriented business. Charging arbitragers breaks new ground for traditionally they have seen themselves to be tippees and "essentially . . . outsiders with no fiduciary or other obligations to companies whose shares they buy or sell."[88]

Solomon and Salsbury have entered guilty pleas in the case and are still to be sentenced.[89] While awaiting further details to be reported of their part in the scheme alleged, it remains to be seen whether the SEC will be able to successfully prosecute such arbitragers upon bases other than those found in the fiduciary-relationship rule of Dirks.

Finally, it should be noted that in the wake of the Levine investigations a new development in private legal remedy for improper insider trading will soon be tested. A damage suit has been brought by Litton Industries Inc. (herafter "Litton") against Levine on the grounds that his manipulation of Itek Corporation stock, prior to Litton's announcement of a substantial tender offer for Itek in January 1983, "artifically inflated" that stock's price.[90] Claiming that as a result the corporation was forced to pay "substantially more" for Itek than it otherwise would have, Litton is seeking thirty million dollars in damages.[91]

What success Litton will have must, of course, await a Court's ruling. It has been noted that securities lawyers feel Litton will have difficulty proving that Levine's insider trading was materially responsible for driving up the price of stock and tender offers re Itek, as the takeover had been rumored widely for months prior to its announcement.[92]

What provisional conclusion can be made regarding the legacy of Chiarella and Dirks? Many predicted dire consequences in terms of the SEC's expected inability to enforce insider trading regulations due to the restrictive principle of liability espoused in these two cases.

It is instructive to note that despite these fears, the SEC has been able to regulate effectively, utilizing alternative grounds of liability. That is, the subsequent development of case law has not been through the application of Chiarella and Dirks, but rather has evolved into two alternative modes of founding liability on insider trading – the Dirks "constructive" or "temporary" insider of footnote fourteen, and the application of the misappropriation theory. Thus, while the corporate fiduciary theory of liability in Chiarella and Dirks remains unchallenged, these two alternative theories of liability continue to evolve. The balance to be struck among these apparently competing theories of liability will be canvassed in the concluding Chapter.

CHAPTER IV

FOOTNOTES

1. Chiarella v. United States 100 S.Ct. 1108 (1980) at 1119.
2. Ibid. at 1120.
3. Ibid. at 1123.
4. 664 F.2d 12 (2d Cir. 1981), cert. denied 104 S.Ct. 193 (1983).
5. 664 F.2d at 16.
6. Ibid. at 15.
7. Ibid. at 15-16.
8. Ibid.
9. [1981] Fed. Sec. L. Rep. (CCH) para. 98,024 at 91, 301.
10. Supra, note 4, 664 F.2d at 16.
11. Ibid. at 17.
12. Ibid.
13. Ibid. at 18.
14. Ibid. at 17.
15. E.M. De Cristoforo, "Trading On Confidential Information - Chiarella Takes An Encore: United States v. Newman" (1982) 56 St. John's L. Rev. 727 at 733.
16. Ibid. at 733, 734.
17. Ibid. at 740, 741.
18. 86 L Ed 2d 215 (U.S.S.C. 1985).
19. Ibid. at 218, 219.
20. Ibid. at 224.
21. Ibid. at 226.
22. Ibid. at 226, n. 22.

23. See SEC Report on post-Dirks case - law developments to the House of Representatives Commerce Committee, August 23, 1985, as reviewed by J.G. Gillis, "Securities Law and Regulation" Financial Analysts Journal (January-February, 1986) 13.

24. See Gillis, ibid. at 4.

25. [1983-84] Fed. Sec. L. Rep. (CCH) para. 99,526 (S.D.N.Y. 1983); aff'd. 745 F.2d197 (2d Cir. 1984), cert. denied U.S.S.C. (1985).

26. 745 F.2d 197 at 199.

27. 48 Stat. 881, as amended, 15 U.S.C. para. 78j(b), 78n(e) 1982.

28. Supra, note 25 at 97,028.

29. H.T. Wilkinson, "The Affirmative Duty to Disclose After Chiarella and Dirks" (1985) 10 J. Corp. L. 581 at 599.

30. Supra, note 26 at 202.

31. Ibid. at 203-204.

32. Ibid.

34. 578 F. Supp. 425 (S.D.N.Y. 1984).

35. Ibid. at 437.

36. Ibid. at 438.

37. Ibid. at 439.

38. 590 F.Supp. 756 (W.D. Okla. 1984).

39. Ibid. at 758-762.

40. Ibid. at 765.

41. Ibid. at 766.

42. See SEC Report, as reviewed in Gillis, supra, note 23 at 16.

43. 601 F. Supp. 685 (S.D.N.Y. 1985).

44. Ibid. at 703.

45. Ibid. at 717.

46. Ibid. at 718.

47. See SEC Report, as reviewed in Gillis, supra, note 23 at 16.

48. 612 F. Supp. 827 (D.C.N.Y. 1985).

49. <u>Ibid.</u> at 829, 830.

50. <u>Ibid.</u> at 832.

51. <u>Ibid.</u> at 834.

52. <u>Ibid.</u> at 840.

53. <u>Ibid.</u> at 841.

54. <u>Ibid.</u>

55. <u>Ibid.</u> at 842; and see V. Brudney, "Insiders, Outsiders and Informational Advantages Under the Securities Laws" (1979) 93 Harv. L. Rev. 322 at 329.

56. <u>Supra</u>, note 48 at 842.

57. <u>Ibid.</u>

58. <u>Ibid.</u> at 846.

59. <u>Ibid.</u>

60. Winans was sentenced to eighteen months in gaol, a $5,000 fine and Probation for five years with 400 hours of community work service.

61. <u>United States v. Carpenter et al</u> (1986) [1986] Fed. Sec. L. Rep. (CCH) para. 92,742.

62. <u>Ibid.</u> at 93,609, Pierce C.J.

63. <u>Ibid.</u> at 93,610.

64. <u>Ibid.</u> at 93,611.

65. <u>Ibid.</u>

66. See Wilkinson, <u>supra</u>, note 29, at 601.

67. 103 S.Ct. 3255 at 3262, note 14.

68. See S.M. Beck, "Of Secretaries, Analysts and Printers: Some Reflections on Insider Trading" 8 Can. Bus. L. J. 385 (1983-84) at 393, note 49.

69. 570 F. Supp. 1397 (C.D.Cal. 1983).

70. <u>Ibid.</u> at 1402, 1403.

71. <u>Ibid.</u> at 1403.

72. <u>Ibid.</u>

73. <u>Ibid.</u>

74. [1985] Fed. Sec. L. Rep. (CCH) para. 92,004 at 90,967 ff.

75. Ibid. at 90,979.

76. Ibid.

77. [1985-86] Fed. Sec. L. Rep. (CCH) para. 92,761 at 93,703.

78. SEC v. Levine et al. [1986] Fed. Sec. L. Rep. (CCH) para. 92,917 at 93,481.

79. Ibid.

80. Ibid.

81. [1986] Fed. Sec. L. Rep. (CCH) para. 92,712, Current Binder.

82. Ibid. at 93,446.

83. Ibid.

84. Ibid.

85. For a brief review of the status of this case, see F. Harrison, "Wall Street Starting to Feel the Big Chill" The Financial Post (14 June 1986) 13.

86. J.M. Laderman and C. Farrell, "Are the 'Arbs' Too Cozy With Insiders?" Bus. Week (16 June 1986) 32.

87. Ibid. at 33.

88. Harrison, supra, note 85 at 13.

89. P.L. Zweig and B. Ingersoll, "SEC Extends Its Insider Trading Probes to Officers of Certain Banks, Sources Say", Wall Street Journal (5 September 1986) 2.

90. "A Suit That Strikes Back at Insiders", Bus. Week (1 September 1986) 48.

91. Ibid.

92. Ibid.

CHAPTER V

ANALYSIS OF RATIONALE OF INSIDER TRADING REGULATION

(a) INTRODUCTION

The lure of insider trading is always there. Information is the most "precious commodity" on Wall Street and advance information of "tomorrow's merger, tender offer, or sensationally good-or-bad earnings report offers a short cut to riches that is growing irresistible".[1] Insider trading is a symptom of very extreme competition for information that goes on in the market place. Henry G. Manne, author of Insider Trading And The Stock Market,[2] commented on the significance of such market information:

> "In many respects, the entire stock market is a complex arrangement for the marketing of information. In an investment market characterized by great risk, a high premium will normally be paid for reliable information . . . As a market is subjected to more uncertainty, information about the possibility of change and its actual occurrence become more valuable. The different amounts of profit of different individuals will reflect their different degrees of sophistication and the reliability of their information. The stock market is, par excellence, the arbiter of the value of information."[3]

The extent to which insider trading should be regulated depends very much on your theory of how the market place ought to function. Those who believe in maximum market efficiency want the least regulatory interference with the flow of information. Those who argue for fairness in the market place want regulation of insiders with access to information that is not available to other investors. There are the competing interests of large, institutional investors versus the interests of small, individual investors. To what extent should insider trading be regulated? In this chapter we will examine the opposing views. The present Chairman of the Ontario Securities Commission has commented that:

> "The scope of the rule that one opts for in insider trading depends upon the rationale chosen to justify its prohibition."[4]

With this in mind, we will now examine the various rationales for the regulation or de-regulation of insider trading.

(b) ARGUMENTS AGAINST THE REGULATION OF INSIDER TRADING

(i) Insider Trading as a Form of Compensation for Entrepreneurial Activity:

Henry Manne, proponent of this theory, advocates unregulated insider trading as an appropriate form of compensation for entrepreneurial activity. Manne distinguishes entrepreneurs from capitalists, who risk their financial resources, and managers who do the predictable.[5]

> "The dynamic, radical, destructive competition of new products, new methods or new organizations (are) all the hardwork of the entrepreneurs."[6]

Manne views insider trading as a reward for the entrepreneur. In his view, rewards of bonuses or stock options limit the employee to a "specific reward no matter how great his innovation."[7] There is no such limitation on the effectiveness of insider trading as compensation:

> "Insider trading meets all the conditions for appropriately compensating entrepreneurs. It readily allows corporate entrepreneurs to market their innovations. As we have seen, this is not a direct marketing of the idea but rather a "sale" of information about an innovation. Thus, although we do not allow entrepreneurs a direct proprietary interest in their ideas, we can allow them recovery for their ideas by permitting them to exploit information about the existence of the ideas in a market based primarily on information."[8]

A valid criticism of this theory and one that has been voiced by several commentators is that insider trading is harmful because it creates a "moral hazard"[9] by allowing insiders to profit on bad news and by permitting management to be rewarded for failures:

> "There is no reason whatsoever to give extra compensation each time management scores a significant failure, and every reason to bar anything which could dilute the incentive to avoid failures, even if one allows that trading profits are probably far from sufficient to induce the affirmative creation of failures. Further, insider trading on bad news creates the same problem as trading on good news in terms of stock market performance, except that there is an added dimension: insiders are able to ease out of their investments whilst stockholders are left to hold the baby."[10]

(ii) Insider Trading: Economic Considerations - Improving Price Performance In Stock Market

Manne calls for an economic consideration of insider trading. He argues that the stock market is improved by insider trading. He states that there would be more continuity in the market place as price changes between consecutive transactions would be gradual whereas if insider trading is barred there will be sudden price jumps on public disclosure of information. Thus, persons trading on inside information have a positive influence on prices in the market place.[11]

> "Manne's theory depends on the notion that insider trading will drastically improve price performance in the stock market by causing prices to reflect underlying values more accurately and initiating gradual rather than sudden price movements."[12]

The same commentator recently has referred to an empirical study which indicates that such market impact is in fact unsubstantial.[13] Professor H. Wu, in "Corporate Insider Trading In The Stock Market 1957-1961"[14], found that the total market transactions by all insiders in their corporations' shares amounted to only one percent of the total New York Stock Exchange volume[15] and further that:

> "There is no indication that public trading volume was affected by insider trading. Thus, substantial impact of insider trading on stock prices could not be expected."[16]

The conclusion reached by Professor Wu should be put in perspective in that it is a study that is now over twenty years old. Further, in practice, investment analysts in their search for relevant market information, follow insider trading reports closely.

Another contention of Manne is that de-regulation would not significantly harm investors.[17] This is a theory that is expressed by other economists, and academics such as Professor Michael P. Dooley.[18]

(iii) <u>Insider Trading - Who Is Harmed?/Ineffective Regulation</u>

Dooley asserts that a correct assessment of the demand for insider trading prohibitions determines "not only the quantity of the enforcement but also the legitimacy of the substantive regulation itself."[19] Investors must be the primary beneficiaries of insider trading regulations "to justify the existence of the regulation".[20] Dooley asserts that:

(a) The legal system has been ineffective in regulating insider trading;

(b) To regulate insider trading - the demand for regulation must be derived from direct or indirect harm that insider trading causes investors;

(c) The Courts and the SEC have exceeded their authority under existing securities laws since evidence demonstrates that insider trading does not harm investors.[21]

Dooley reviews the incidence of insider trading enforcement and finds that there is a low rate of enforcement. He then examines various factors that he views as the cause, notably budget constraints, the fact that a large part of the SEC's limited resources are consumed by routine regulation, such as reviewing registrations, reports and over-seeing the market. But he states that it is in the nature of the offence of insider trading itself that the problem lies:

> "Given limited resources for enforcement, insider trading has certain characteristics that place it low on the SEC's list of priorities. To facilitate discussion thus far, the offence of insider trading has been sketched with clear, simple lines. In the reality of an adversarial proceeding however, the line between legality and illegality becomes blurred, and proving that given behaviour should be characterized as a violation is

seen as a difficult, complex undertaking of uncertain success."[22]

Dooley asserts that the combination of the complexity of insider trading regulations and the "scarce" enforcement personnel of the SEC has led to very ineffective regulation of insider trading by the legal system.

Dooley then argues that it is difficult to show a "causal connection" between insider trading and market losses suffered by investors. His premise is that the demand for regulatory laws must be derived from the harm such activity would cause society:

> "The existing system cannot be justified by showing that insider trading is 'wrong' in the sense of being undesirable, unethical or even unfair. Insider trading must be shown to harm investors, directly or indirectly, in a particular way to fall within the proscriptive scope of Section 10(b)."[23]

Dooley challenges the rationale of regulating insider trading by asserting that since direct harm caused by insider trading cannot be evidenced in exact numbers that it cannot be proven that significant harm is suffered by outside investors. Manne made a similar argument that de-regulation would not significantly harm "long-term" investors. Manne categorized investors as:

(i) long term - that is, those investors whose market decision was a function of time;

(ii) short term - those investors whose market decision was a function of prices; and.

(iii) those investors transacting on both bases (i) and (ii).[24]

He argues that it is the short-term investors who lose on the basis of price, whereas those who gain do so on a 'time basis' and it is these investors, that is the long-term investors, that Manne argues we should be concerned with:

> "Thus, there is both a plus and a minus for outside sellers from insider trading. The plus is the higher price received by those who would otherwise have sold at the stable, lower price, and the minus is the number of sales that now occur but which otherwise would not have occurred. It would be extremely difficult to obtain accurate data on this question, though we can make one safe assumption. Those sellers who lose will

tend to be those whose trades are a function of prices, and those who gain will tend to be those whose trades are a function of time only."[25]

Manne argues that concern should be concentrated on the long-term investor rather than the short-swing trader. Who is the long-term investor? Jenny Cottrell in "Insider Dealing In The U.S." has viewed it as follows:

> "The long-term investor is much less likely than the trader to sell because of price changes effected by insiders. He is more likely to become a seller because of changed financial circumstances or death."[26]

The same commentator has asserted that this contention rests on the 'false assumption' that long-term investors transact on a 'time' basis rather than being influenced by the prices of the security:

> "In reality, most investors tend to own more than one security and if they require cash, they will indeed consider price in deciding when to sell: even long-term investors reach points at which they decide to 'take a profit' or 'cut the loss', and a prospective buyer for a long-term investment will often hold off on his purchase until he considers that the price is right. If insider dealing on undisclosed information causes any price movement or delay on disclosure, usually the long-term investors will still be hurt, and often significantly."[27]

But surely the most powerful challenge to Manne and Dooley's thesis that there is no direct quantifiable harm is that the harm may be to the market itself. Potential investors may not have confidence in the market if they see that some market participants are permitted to trade on the basis of information not generally available. One must consider the impact on the public's confidence in the stock markets and the financial health of those markets is only maintained if the public considers them to be safe places for investment.

(iv) <u>Insider Trading: Delay In Publication</u>

An argument advanced in favour of insider trading regulation is that insider trading harms outside investors because it creates an "incentive for insiders to delay the publication of information to exploit it themselves."[28]

The argument goes that favourable information "ripe for release" at the close of business on Monday could be delayed until the close of business on Wednesday to allow insiders to purchase on Tuesday. All persons then who sold in ignorance on Tuesday are worse off.[29] Dooley challenges this argument:

> "This contention not only conveniently ignores that all those outsiders who bought on Tuesday are better off, but it is also overinclusive. Merely because insider trading can result in undue delay does not mean that it always does or even that such delay will occur often enough to justify a limited rule prohibiting insider trading that results in delay."[30]

Daniel R. Fischel refers to this 'timing of disclosure' argument as well in "The Regulation Of Insider Trading".[31] Fischel argues that there is little empirical basis to support the contention that insider trading causes the disclosure of information to be delayed.[32] He views insider trading as an 'additional method for communicating information':

> "Our analysis demonstrates, moreover, that delaying disclosure of information may be beneficial in some situations. For example, some valuable information should be kept from competitors if it is to retain its value. Furthermore, the argument assumes that all information can be disclosed. But information such as revisions of probabilities of future states cannot necessarily be conveyed directly. In cases where disclosure otherwise would be either undesirable or impossible, insider trading gives firms an additional method for communicating information. Finally, insider trading in some cases may accelerate the speed of disclosure because the ability to profit is dependent on information reaching the market. Thus insiders, if allowed to trade, may have strong incentives to communicate information to the market."[33]

Economists therefore argue that there will be no delay in information reaching the market if insider trading is recognized as a form of disclosure.

(v) <u>Insider Trading: Fundamental Difference Between Legal And Economic Definitions</u>

Daniel Fischel has pointed out that there is a 'fundamental' difference between the legal and economic definitions of insider trading:

> "Insider trading in an economic sense is trading by parties who are better informed than their trading partners. Thus, insider trading in an economic sense includes all trades where information is asymmetric. This definition includes all trades, whether or not in securities, where one of the parties has superior information. By contrast, federal law has focused on purchases or sales by certain insiders within a 6-month period or on trading on the basis of 'material' information by a broader more amorphous group of insiders or their tippees. Insider trading in an economic sense need not be illegal. The law never has attempted to prohibit all trading by knowledgeable insiders."[34]

Fischel has stated in his case comment[35] on <u>Dirks v. Securities and Exchange Commission</u> that the majority and dissenting opinions in this case both evidenced a "disregard for principles of economics".[36] Fischel argues that questions such as the effect of insider trading on a firm's investors and the role of the analyst in communicating information to the market are economic, and not legal questions:

> "It is impossible to formulate rational legal rules governing these situations without some understanding of the economic consequences of different kinds of actions. Without such an understanding, legal analysis is reduced to a vacuous recitation of cliches and talismanic phrases devoid of analytical content. If insider trading is beneficial to investors because it increases their wealth, for example, it would be irrational to interpret the fiduciary duty owed to investors, the supposed beneficiaries of fiduciary duties, as prohibiting the practice."[37]

It is important to note this discrepancy between economic theory and legal theory in the evaluation of insider trading. Fischel takes a strong position namely that any analysis in this area must be based on economic principles, almost it would appear to the exclusion of a consideration of legal principles of regulation and control. Other commentators have argued for this emphasis on economic issues imbedded in the problem of insider regulation. Professor H. Wu in "An Economist Looks At Section 16 Of The Securities Exchange Act Of 1934"[38] states that the Securities and Exchange Commission should have economic as well as legal counsel:

> "The Commission, dominated by lawyers in zealous pursuit of "fairness" and "protection of investors", too often fails to recognize the economic ramifications of such regulation. The public interest is undoubtedly related to the efficient

functioning of the economy; it is best served by regulation that takes into account both economic and equity considerations. As William L. Cary, former Chairman of the Commission has said ... there has been too much dominance of lawyers and legal thinking in the work of the Securities and Exchange Commission ... The Commission can never afford to be without economic as well as legal counsel."[39]

With this in mind, consideration should be given to the economic theories relating to the efficient functioning of capital markets. An illustration of this approach is the consideration of the most common argument against insider trading, namely that it is unfair or immoral, from the economist's point of view.

(vi) Fairness Argument - Economists' View

The most powerful argument against insider trading is that it is unfair to outside investors. Fischel refers to some commentators like Schotland who argue that even if it is found that unregulated insider trading brings economic gains, those gains must be foregone in order to obtain non-economic goals such as fairness, just rewards and integrity.[40] Fischel notes that what is usually left unsaid is how and why insider trading is unfair. Fischel's premise is that insider trading should be viewed as a desirable compensation scheme which benefits insiders and outsiders alike rather than one in which insiders profit at the expense of outsiders. Insider trading by providing incentives to increase the value of the firm increases the size of the pie so that everyone benefits:

> "A more powerful response to the argument that insiders profit at the expense of outsiders is that if insider trading is a desirable compensation scheme, it benefits insiders and outsiders alike. Nobody would argue seriously that salaries, options, bonuses and other compensation devices allow insiders to profit at the expense of outsiders because these sums otherwise would have gone to shareholders. Compensating managers in this fashion increases the size of the pie, and thus outsiders as well as insiders profit from the incentives managers are given to increase the value of the firm. Insider trading does not come 'at the expense' of outsiders for precisely the same reason."[41]

Fischel therefore sees no tension between fairness and efficiency. The basis of Fischel's theory however is that the firm as a matter of contract should be able to allocate property rights in valuable information to managers or investors, that is to say that shareholders would voluntarily enter into contractual arrangements with insiders giving them property rights in information. He argues that the parties' self-interest will lead them to reach by private agreement the "optimal allocation of what is simply one element of a compensation arrangement."[42]

It will be noted that Fischel's theory of the use of insider trading as a compensation scheme is similar to Manne's and therefore the problem of "bad news" or rewarding management for failures undermines Fischel's theory as it does Manne's. There is also the objection that persons in corporations who are not entitled to exploit information will nevertheless have access to this information.[43]

(vii) Efficient Capital Market - Information Effects

It is instructive in examining the rationales surrounding insider trading to examine the economists' vision of the functioning of capital markets. Economists have evolved an "Efficient Capital Market Hypothesis" which has been described by Christopher Paul Saari in "The Efficient Capital Market Hypothesis, Economic Theory and The Regulation Of The Securities Industry", as follows:

> " The statement that security prices fully reflect available information - which is to say that capital markets are efficient - is of great significance in two respects. On a societal level, it implies that the market uses all available information to allocate resources. Capital will flow to the most profitable investments which, in a market economy, are reflections of society's values. Market efficiency at the same time is significant to the individual investor. Under conditions of efficiency, no investor, using only information also generally available to other investors, can systematically identify and acquire undervalued (or overvalued) securities.
>
> Despite its significance as a general assertion, the statement that security prices fully reflect available information is not sufficiently precise as such to be empirically tested and verified. To provide an empirically testable assertion, three factors must be specified with

particularity: the determinants of security values, the processes of security price information and the characteristics of prices that "fully reflect" available information.

Investors may purchase assets, including securities, for many reasons. Nothing theoretically compels investors to value assets by any particular method. Thus, assumptions must be made about investor behavior to develop any theory of asset valuation. Economists often hypothesize that investors value assets according to the future monetary rewards - or "expected returns" - associated with those assets, after adjusting for "risk", the degree of certainty with which the expected returns can be predicted. Based on this assumption, economists have developed what is known as portfolio theory, which can be combined with other economic theory to explain price determination in capital markets. The implications of portfolio theory for security price determination combined with the ECMH assertion that prices fully reflect all available information yield the proposition that, in an efficient market, all available information is used to determine expected returns on securities, and therefore to establish security prices. If all available information is incorporated into security prices, investors cannot use available information to identify mispriced securities. Prices that reflect all available information are sometimes referred to as "fair game prices".

If securities markets operate in accordance with the ECMH, securities prices are such that the expected returns are equal for all securities having the same degree of risk. The realized returns on all securities in the same risk category need not be equal; realized returns may and will vary. Nevertheless, ex ante, all securities in the same risk category have the same changes of gain or loss; their expected returns are equal."[44]

The Efficient Capital Market Hypothesis demands for the achievement of maximum efficiency, "the most prompt disclosure of material and significant information relating to the securities of companies which can possibly be made".[45] The informational effects of such prompt disclosure are that prices will more accurately reflect such information, that is the objective is that the price of securities always conveys the most accurate information in an efficient market. Information with respect to companies is constantly subject to analysis by market professionals and financial analysts. Their role will be considered in due course, but it is important to note here that their analyses are reflected in market prices "which thereby tend to approach a collective analytical judgment as to the "intrinsic' value of the securities".[46]

Economists criticize the insider trading regulations for causing a "reporting gap" by their "abstain or disclose" rules with respect to material and significant information. That is, the legal rules surrounding insider trading interfere with the efficiency of the capital market:

> "These combined gaps clearly detract from the efficiency of securities markets. They permit securities transactions to occur in markets in which not all material information exists. Improvements in efficiency can occur only if reporting is required promptly after the occurrence of an event which is of significance in determining the consensus of professional analysts or others as to security values. If these gaps cannot be sharply reduced by requirements for more rapid disclosure, an argument can be made for permitting significant information to reach the market even if indirectly injected into the market by holders of significant undisclosed information. Such indirect disclosure would be immediately expressed in the volume of trading and the price movement of the securities which is the subject of the information."[47].

Economists argue that possible unfairness to individual investors who do not possess such inside information, and who may suffer a pecuniary loss, may be outweighed by the benefit to the large number of investors in permitting such information to reach securities markets.

It is interesting to note that economists view the 1930's securities legislation from a different perspective than that of the regulators. Economists emphasize the purpose of the legislation as being "to improve the economic functioning of the capital markets to achieve better resource allocation".[48] The SEC perceives the primary purpose of the securities laws to be the protection of investors, although there has been some recognition of the economist's perspective. Economists have with great complexity made their argument that a consideration of economic factors alone should govern proper trading in the market place. But the issues of protection of the investing public and the maintenance of public confidence in the market place must also be addressed. It is submitted that these particular perspectives of economists and regulators may not be as divergent as first appears. As has been noted in a Canadian context by the Kimber Report[49] the two views may be compatible in the following way:

> "Establishment of conditions and practices in the capital market which best serve the investing public will normally be consistent with the best interests of the whole economy. For example, disclosure of financial information which depicts adequately the operations and financial position of companies is vital to the investing public; such disclosure also provides the capital market with the information necessary to make a more satisfactory allocation of resources."[50]

It is a question of balancing the need for a free and open and therefore efficient securities market with the need to protect the investing public from abuses to that system. This balancing of goals will be discussed in more detail in the section to follow dealing with Regulators' views and rationales for insider trading.

(viii) Role of the Financial Analyst: Economic Analysis

Any consideration of the economic theories regarding insider trading should not conclude without an examination of Fischel's analysis of the role of the financial/investment analyst in the market place. The functioning of investment analysis took on great significance following the U.S. Supreme Court decision in Dirks. As discussed previously, Dirks was an investment analyst and the Supreme Court gave important consideration to his liability as an analyst for alleged insider trading as a non-traditional insider. Of course, the Supreme Court's decision absolved Dirks of such liability but in reaching that conclusion, the Court examined the financial analyst's role in the market place. Fischel's view is that although the majority opinion refers to the important role of the financial analyst in the operation of capital markets, "much of its (the Court's) analysis reflects a lack of understanding of the implications of this principle."[51]

The majority opinion in Dirks stated that trading by insiders on the basis of insider information is a breach of fiduciary duty. Further, Fischel states the Court:

> "assumes that both analysts and insiders act illegally in most cases if valuable information is communicated to analysts,

who in turn disseminate it to their clients. The insider breaches his fiduciary duty by communicating the information to analysts; the analyst who does not abstain from using the information is a participant after the fact in the insider's breach."[52]

Even though Dirks is clearly considered a favourable decision for financial analysts in that it restricts their potential liability under insider trading laws (as discussed previously, the Court held that only the analyst's receipt and use of information from an insider who receives a direct or indirect 'personal benefit' constitutes a violation of law by both the insider and the analyst), Fischel nevertheless objects to this decision. He argues that analysts should be completely unfettered in their use of inside information, "free of legal rules restricting the use of inside information",[53] because of the benefits they bring to the market.

What are these benefits? Fischel states that the market benefits from the work of analysts in several ways. Analysts serve as conduits for the transmission of market information as well as serving as a monitoring function.[54]

> "Because managers may disseminate false information about the firm, or may attempt to conceal negative information, analysts have incentives to engage in some search themselves before making recommendations to their clients. This monitoring activity is a natural complement to the role of analysts in communicating information about the firm to investors."[55]

Fischel states that the use of analysts benefits firms and investors alike. They enable firms to communicate information more cheaply than if all information had to be disclosed publicly, and importantly since analysts have a comparative advantage over investors in interpreting, verifying and seeking out information, investors will engage in a less wasteful search for information if they can rely on analysts' recommendations.[56] Another commentator, Harry Heller has referred to the operation of analysts in the Efficient Capital Market:

> "Indeed there is empirical evidence that this type of constant analysis and forecasting of earnings results in changes in the volume and market values of the securities and is an essential basis for the assumptions underlying the Efficient Capital

> Market Hypothesis itself. A market in which all the available information is, in fact, available, tends to reach market values which reasonably portray intrinsic values."[57]

Fischel argues that the effect of applying insider trading laws to the investment analysts is to raise the cost to firms and investors of using them to communicate valuable information. Firms voluntarily transmit information to analysts as an efficient method of communicating information, and the application of insider trading laws to analysts interferes with this, he argues, so that firms will have to rely on more costly means of transmitting information, and this higher cost operates ultimately to the detriment of investors.

> "Analysts, according to the current legal rules, may search for information themselves and analyze publicly available information, but they may not receive 'inside' information unless they publicly disclose it. Public disclosure, of course, is not a realistic possibility, because it will cause the information to lose its value. Nobody will pay an analyst for information that he must publicly disclose before selling it to his clients. Firms might not communicate information to analysts, moreover, if analysts must disclose it, since the desire to avoid disclosure might be the firm's reason for using an intermediary."[58]

But Fischel qualifies this pessimistic view by noting that the magnitude of the effect on analysts and the market depends on how efficiently insider trading laws deter the transmission of information and he notes that because of the materiality requirement[59] legal rules may have only minimal deterrent effect.

Fischel notes that proponents of insider trading laws might view his arguments regarding increased costs to investors in obtaining information as "irrelevant" since "the legal prohibition against insider trading has never focused on efficient methods of compensating corporate managers or of communicating information to investors."[60] In the following section on the regulators' view of insider trading, we see their focus, namely on considerations of fairness, particularly the "perceived unfairness of one group of investors having access to valuable information in advance of others."[61]

(c) THE REGULATORS' VIEW: RATIONALES SUPPORTING INSIDER TRADING REGULATION

> "To judge by some public comments, many on Wall Street regard insider trading as nothing more serious than exceeding the 55-mph speed limit - a law that nobody believes in or follows. There is even a modest body of legitimate academic opinion that supports the notion that, to make the markets more efficient, insider trading should be legal anyhow. The faster the information gets into the public domain, the argument goes, the smoother the market process."[62]

We have looked at the arguments against the regulation of insider trading. It is instructive now to examine the rationales supporting such regulation. Such rationales are founded on principles of fair dealing in the market place, the protection of the investing public and the promotion of public confidence in the stock markets which are an essential part of any country's commercial and financial structure.

(i) Fairness in the Market Place

Promotion of fair dealing in the market place is one of the key arguments in favour of the regulation of insider trading. A recent commentator in this area, Jenny Cottrell, makes reference to the wording of the original legislation in this area, namely the Securities Exchange Act of 1934 and she notes that this act calls for "fair dealing" in not one but six sections,[63] twice calls for a "fair and orderly market"[64] and cites protection of investors as one of its dominant goals.

As well as the wording of the legislation which calls for fair dealing, it is important to note that the investing public as a whole, has an expectation that this element of fairness in the market place will be protected and promoted. A commentator on the present climate on Wall Street has noted the following:

> "Efficiency is certainly to be desired but the myopia of many on Wall Street reeks of political naivete. Beyond the canyons of Wall Street, fairness is what people want from the stock market. As long as people believe they have an even shot at getting rich - as long as a level playing field exists - the public will put up with nearly anything, including ostentatious displays of wealth by Wall Street hot shots."[65]

Economists, academics and many investors know that the market is full of arbitrary advantage. Those who can afford it buy the best information in terms of using the resources of the investment and financial analysts for example. But it is not this type of advantage that challenges this sense of fairness. The capitalist economic system is full of arbitrary advantage to some players but the public views it as a fair game because all are playing within the rules, taking the same risks. Insider trading threatens this sense of fairness, this idea of the "level playing field". Since the insider has access to information that is not available to the general public, if he is allowed to trade on this information, it is unfair to other investors in that he is not taking a risk as other investors are:

> "This is an extension of the fair game model. Since the insider is not taking a risk, he is not playing within the rules. Referring back to the fair game analogy, this would be similar to letting one player rummage through the deck to pick his cards."[66]

Arthur Levitt Jr., chairman of the American Stock Exchange has commented recently that "there is a growing perception that in an increasingly unregulated marketplace, the little guy stands to lose. The notion that a small group of investors is taking advantage of its position of power is very dangerous."[67]

Market commentators have noted that aside from inside trading cases, the small investor was beginning to resent "Wall Street greenmailers squeezing a higher price for their stock from corporate managements that was available on the market."[68]. As well, program trading has made individual investors nervous. Large institutional investors can lock in profits by trading stock - index futures and huge blocks of equities but this program trading makes the market extremely unpredictable[69] and it is considered one of the factors in the sharp drop on the New York Stock Exchange in September, 1986.

The mandate of the U.S. Securities and Exchange Commission is to ensure that the nation's capital markets operate with fairness and integrity so that investor confidence is promoted. The recent highly publicized case of Dennis B. Levine, noted previously, illustrates the SEC's success in uncovering a large insider-trading scheme. On May 12, 1986 Levine was charged with using confidential information to gain $12.6 million in illicit profits from trading the securities of 54 companies. He subsequently entered an offer to settle but has plead guilty to four felony charges. This case is very important to the SEC in that it very visibly demonstrates that the SEC is enforcing insider trading regulations:

> "In breaking such a complicated and sensitive case, the SEC not only demonstrated its sleuthing tenacity but also laid to rest any doubts about its willingness to carry its campaign against insider trading into Wall Street's inner sanction."[70]

Levine, a managing director of an investment bank, is the first senior banker to be caught by the insider trading regulations. The case represents a significant victory for the SEC enforcement branch, with one commentator calling it "a real stunner, a grand-slam home run".[71] But other commentators have noted that the Levine scandal has reinforced the widespread suspicion that there is something rotten on Wall Street.[72] Peter A. Cohen, chairman and chief executive officer of Shearson Lehman Brothers, where Levine worked as an investment banker before becoming a managing director at Drexel, has called the Levine affair "the worst disaster for Wall Street in the last 10 years."[73] The reason for this view is that a scandal of insider trading like Levine can produce a backlash. Public confidence can turn against investment bankers and others who use inside information for their own personal gain.

(ii) Promotion of Public Confidence in the Market

One of the least quantifiable but most important rationales for the regulation of insider trading is that such regulations promote public confidence in the stock market, confidence that the market is fair and equitable. What contributes to public confidence in the marketplace is the knowledge that insider trading regulations are there to protect investors from being cheated by insiders with better access to information, and the assurance that the SEC will actively enforce such regulations. Professor Dooley would argue that if confidence were the issue, corporations would signal their internal enforcement rules to the market.[74] The problem with this contention is credibility and quantifiability. In terms of credibility, it is not clear that the market would trust corporations and with regard to quantifiability, any gains from a corporation's extraordinary measures to earn trust would be hard to measure.

The Levine case illustrates quite dramatically the importance of this intangible factor of public confidence. The case has created concerns on Wall Street that unless something is done to indicate that market players are cleaning up their act, that Congress may feel compelled to react legislatively in response to the public outcry over such blatant cases of insider trading. Samuel L. Hayes III, a professor of investment banking at the Harvard Business School has commented that "the public is ready to believe there is something wrong on Wall Street because of an underlying disgust over the windfall profits individuals and institutions are making," but Hayes has stated that if the Levine scandal widens or others are uncovered,

> "It could create an environment where legislators feel they must clamp down to restore the public's confidence that the markets are fair."[75]

Over the past decade the U.S. government has reduced its intervention in the market on the basis that a free financial market is more efficient and therefore more beneficial to the economy. As we have noted, some market economists favour deregulation of insider trading. But it is important to remember that Congress gave the SEC expanded authority and toughened penalties with relation to insider abuses in the 1984 Insider Trading Sanctions Act. Any weakening of public confidence in the markets would have an effect on capital investment and one thing that shakes public confidence is unchecked insider trading. Arthur Levitt, Jr., as indicated, chairman of the American Stock Exchange has noted that:

"If the investor thinks he is not getting a fair shake, he is not going to invest and that is going to hurt capital investment in the long run."[76]

So significant are the repercussions of Levine in the market community that tougher enforcement of insider trading laws has been recently discussed publicly by senior investment managers. Frederick H. Joseph, chief executive officer of the investment bank for which Levine worked, Drexel Burnham, in a recent interview to "Business Week" had yet to find the words to convey just how strongly he felt about the "importance of integrity" on Wall Street. To prevent insider abuses, he said that he would be "for tougher enforcement (of existing laws) and maybe even for new legislation."[77]

"A call for a government crackdown would sound odd coming from almost anyone on Wall Street, bastion of self-regulation that it is . . . Joseph's hard-line position reflects the mounting unease not only at Drexel but throughout the securities industry as anti-Wall Street sentiment builds on Main Street."[78]

Joseph and other main players in Wall Street were summoned to Washington last year to appear at Congressional hearings on bills to curb hostile take-overs. Congress to date has failed to enact any new laws, but in the wake of Levine, many Wall Street firms are re-examining their internal controls. Like the stock exchanges, the major brokers have the computer capacity to track all the trades they handle. As well, many firms require that employees trade with the firm exclusively or provide duplicate confirmations of transactions with other brokers. Brokerage houses also employ internal auditors who question employees about their trading activities.[79]

This new emphasis on self-regulation indicates how nervous Wall Street firms are about punitive government action. Wall Street players are trying to de-limit the effects of the Levine case and to present this case as an aberration. But a commentator has noted recently that:

". . .evidence is mounting that the safeguards of investment firms, Wall Street law firms and the SEC itself are not sufficient to protect investors from insider-trading abuses.

Further, the wave of takeovers and mergers has produced an environment in which opportunities abound for making huge profits from non public information. As long as surveillance stays at its present level of effectiveness, the street will be vulnerable to the charge that the Levine case is not an aberration."[80]

Thomas C. Newkirk, the SEC's litigation director who is heading the Levine investigation has commented that "if people are trading on inside information in the belief that they are going to get away with it, this (case) is a challenge to the way they are doing business."[81]

The SEC in enforcing insider-trading cases like Levine, is sending a powerful message to investment bankers and other market professionals. They are not to profit from inside information supplied to them by their clients nor are they to pass this information around to others.

The enforcement of insider trading regulations also sends a message to the investing public that the market is being policed for such abuses and that investors can therefore have confidence that they will be protected from those who trade with unfair advantage due to access to undisclosed inside information.

Despite the technical arguments of market economists for an unfettered market system as discussed previously, it is submitted that the admittedly empirically unquantifiable adverse impact of insider trading violations on the investing public and indeed on institutional investors themselves, justifies the regulation of insider trading to preserve market confidence. This is certainly a legitimate rationale for such regulation. That is, economists have not shown a sufficiently significant gain to compel a different view.

(d) OUTER LIMITS OF THE RATIONALE FOR REGULATION OF INSIDER TRADING: THE NON-TRADITIONAL INSIDER

(i) Professor Brudney's Analysis of the "Disclose-or-Refrain" Rule

> "We have thus seen at one end of the spectrum that the need to encourage private pursuit of information sets limits on the persons and information subject to the disclosure obligations of the antifraud rules; and at the other end, that corporate insiders and their satellites are subject to the disclose-or-refrain rule with respect to material non-public corporate and non-corporate information, and that securities professionals dealing with their clients have similar obligations. But who in addition to those persons should be subject to the disclose-or-refrain rule with respect to what information and on what principle or principles?"[82]

It is clear that the insider-trading provisions of the U.S. securities legislation restricts corporate insiders who would trade on the basis of inside information, but "extension of the law to outsiders who may possess other informational advantages has, so far, been unsystematic."[83] Professor Victor Brudney in considering what rationale should determine the scope of the disclose-or-abstain rule has provided very useful guiding principles. The present chairman of the Ontario Securities Commission, Stanley Beck, has referred to Professor Brudney's theory as the "most thorough . . . and persuasive analysis"[84] of the issues surrounding the choice of rationale to justify the prohibition of insider trading.

Professor Brudney notes that since the Texas Gulf Sulphur decision[85], the "disclose-or-refrain" rule has been applied by the courts in their interpretation of rule 10b-5. This rule states that persons, or at least some persons, who possess material non-public information about the value of a firm's securities cannot buy or sell the securities unless they first disclose the information.[86] Professor Brudney in examining the unsystematic extension of this rule to outsiders or non-traditional insiders, considers whether there is a "satisfactory rationale" for the extensions of disclosure obligations or whether in fact these disclosure obligations should be limited in scope:

"The task is to find the principle which defines and limits the coverage of the concepts embodied in the antifraud provisions."[87]

Professor Brudney refers to the SEC's reliance on the theory of equality-of-information theory, but he points out that the rationale for applying the insider trading prohibitions was expressed by the commission In re Cady, Roberts & Co. by reference to 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."[88]

Professor Brudney's view is that Cady, Roberts access-to-information theory provides the proper rationale for the application of the "disclose-or-refrain" rule rather than the equality-of-information theory. Brudney's analysis is that insider trading prohibitions are "primarily designed to protect the investing public from those who possess an informational advantage."[89] His view was that the application of the "disclose-or-refrain" rule to trading on corporation information by insiders was based not only on notions of fidelity and efficiency but also on considerations of equity. Brudney's important contribution to insider-trading theory in contained in the following passage:

"The inability of a public investor with whom an insider transacts on inside information ever lawfully to erode the insider's informational advantage generates a sense of unfairness. The insider has acquired from the corporation relevant and material corporate information and those with whom he deals cannot acquire it from the corporation lawfully, at least without the corporation's consent, which the insider has reasons to know has not been given and will not be given. Allowing the insider the informational advantage in dealing with outsiders is thought to be "unfair," in the language of Cady, Roberts, presumably because he has a lawful monopoly on access to the information involved. The unfairness is not a function of merely possessing more information - outsiders may possess more information than other outsiders by reasons of their diligence or zeal - but of the fact that it is an advantage which cannot be competed away since it depends upon a lawful privilege to which an outsider cannot acquire access."[90]

The essential element which makes an informational advantage unusable by those who possess it in dealing with those who do not, is the inability of the latter to overcome this advantage lawfully, no matter how great their diligence or how large their resources.[91] The unfairness does not arise from having more information, but in having information access to which is barred to an outsider. This highlights the contrast between the equality-of-information theory and the equal-access theory. The latter theory does not extend so far as to require actual equality or sharing of information. Brudney would only bar trading on information when one party has an "unerodable informational advantage",[92] that is an informational advantage that one party has that cannot be overcome legally by an outside investor. This, argues Brudney, is the proper application of the "disclose-or-abstain" rule. The trading advantage that comes from buying investment advice, or through diligence and resources is not prohibited. These are advantages that can be overcome lawfully:

> "In sum, the logic of the disclose-or-refrain rule precludes exploitation of an informational advantage that the public is unable lawfully to overcome or offset. And while historically the antifraud provisions may be a response only to unerodable informational advantages held by corporate insiders or market professionals (or regulars) even when dealing at arms length, the principle it embodies extends to protecting public investors against transactions by all who possess such informational advantages. It does not detract from this conclusion that there may nevertheless by systematic inequality of lawful access to information by reason of disparities among individual investors with respect to power, wealth, diligence, or intelligence. The values of efficiency in pricing and resource allocation served by encouraging pursuit of information about the worth of securities are diluted, if not destroyed, by a rule purporting to offset those disparities by requiring universal sharing of information."[93]

The question of how to determine whether information was obtained lawfully was examined with great difficulty in Dirks. Beck has commented that the Supreme Court in Dirks appeared to confuse equality of information with access to confidential information.[94] Beck notes that it is important to remember that the theory of equal access is not an "egalitarian one" - the argument is not "for equality of information in the marketplace."[95]

One recent commentator in discussing Brudney's theory has used the analogy of a card game to explore this theory. Insider trading is compared to a card game where one player is allowed to peek at the cards still in the deck:

> "The other players will be at such a disadvantage that it might not be considered 'fair' because different rules apply to different players. If a goal of the securities markets is to give equal access (although at differing costs) to material information for persons trading with each other, an informational advantage should be denied to those who seek to use non-public information that they are precluded by legal restrictions from disclosing to public investors. Under this analogy, if you peek at the cards, you should not be allowed to play that hand or to help another player."[96]

(ii) <u>Supreme Court's Consideration of Brudney's Theory in Dirks</u>

Brudney's theory is a significant one as evidenced by the Supreme Court's reference to it in their formation of guiding principles for those "whose daily activities must be limited and instructed by the SEC's insider-trading rules."[97] The Court in determining whether a tipper had violated his <u>Cady, Roberts</u> duty focused on objective criteria of whether or not the insider received a direct or indirect personal benefit from the disclosure, such as monetary gain or a reputational benefit that would translate into future earnings. The Court in examining the benefit gained by the insider referred to Brudney in this passage:

> "The theory presumably is that the insider, by giving the information out selectively, is in effect selling the information to its recipient for cash, reciprocal information, or other things of value for himself, including possibly prestige or status or the like."[98]

The Court then said there then would be objective facts and circumstances that the Court could examine in determining whether an inference could be drawn that the insider received some personal benefit from the disclosure. Brudney was therefore useful to the Court in its development of realistic working guidelines to the "disclosure-or-refrain" rule.

(iii) Chairman Beck's Comments on Brudney's Theory and Extension of Disclose or Abstain Rule Beyond Traditional Outlines

As commented earlier, Chairman Beck found Brudney's analysis very useful in examining the rationale chosen to justify the regulation of insider trading. Brudney comments that neither the disclose-or-refrain rule nor the insider trading prohibitions are expressly confined to offering protection to public investors against only corporate insiders and market professionals, as opposed to non-traditional insiders or "outsiders":

> "But to give a broader reading to the disclose-or-refrain rule requires a principled basis on which to justify the broader coverage and set limits to it. The notion here offered - that the rule forbids exploiting unerodable informational advantages that one trader has over another - derives both justification and appropriate limits from the policy of the legislation." [99]

Beck approves of Brudney's rationale for justifying the broader coverage of the insider trading rules to non-traditional insiders since Brudney's theory provides a guiding principle as to where the limits to such extended liability should be drawn. However, Beck notes that the "arguments set out above for extending the disclose or abstain rule beyond the traditional categories of insiders to 'outsiders' who possess material non-public information" are not generally accepted by those bodies which consider legislative reform:

> "The major securities law codification projects in the United States and Canada both skirted around the issue. The American Law Institute's Federal Securities Code does not extend liability beyond corporate insiders, those given access to inside information, and their tippees. For other cases, the Code resorts to an ad hoc fairness test by inviting the courts to rely on the Code's anti-fraud prohibition (similar to Rule 10b-5) "to the extent that a sufficiently egregious or shocking or offensive case of trading while silent cannot be rationalized on an 'insider' analysis". The Proposals for a Securities Market

Law for Canada do not discuss the issue directly except to note that the definition of insider that it employs is broader than the OSA and is based directly on the CBCA with the important addition of a residual category that includes those whose relationship to a company gives them access to confidential information. While the precision and breadth of the definitions in s. 12.02 of the Proposal are admirable, it is a matter of regret that neither they nor the Code deal directly with the "inherent unfairness" theory advanced by Brudney."[100]

Beck then applies Brudney's "inherent fairness theory" to Chiarella and Dirks and finds it a useful analysis. Chiarella, a printer and outsider with no direct connection with the offeror-principal, possessed information that was not available to the market and the information could not be legally acquired by those in the marketplace. He therefore possessed an "unerodable informational advantage" and should have been held liable. Dirks is considered an easier case by Beck as he was a market professional, a registrant and a classic tippee. His information came from someone he knew to be an insider, he used that information to his advantage and to the detriment of those who purchased from his tippees.

"Although market-place purchasers could be said to have been able to acquire lawfully the non-public information in the sense that a company may not assert a claim of confidentiality with respect to its own fraud, the reality was that they (as opposed to a market professional) had no way of acquiring the information to which the tippers and tippees were privy."[101]

Therefore Beck applying Brudney's theory finds that liability should have been imposed on the insider (Secrist) and the tippee (Dirks).

It is submitted that Beck's respect for Brudney's "inherent unfairness theory" may play a part in any proposals to amend the present Ontario Securities legislation, in particular as the proposals relate to an extension of the law beyond the category of traditional insiders, to outsiders who may possess unerodable informational advantages. Perhaps Ontario may see a legislated "inherent unfairness" test based on Brudney's rationale of unerodable informational advantage.

CHAPTER V

FOOTNOTES

1. J. Templeman, "The Epidemic of Insider Trading" Bus. Week (29 April 1985) 79.

2. H.E. Manne, Insider Trading and the Stock Market (New York: The Free Press, 1966).

3. Ibid. at 47.

4. S.M. Beck, "Of Secretaries, Analysts and Printers: Some Reflections on Insider Trading" (1986) 8 Can. Bus. L.J. 385 at 394.

5. Supra, note 2 at 117-119.

6. Ibid. at 131.

7. Ibid. at 138.

8. Ibid. at 138.

9. D.W. Carlton and D.R. Fischel, "The Regulation of Insider Trading" (1983) Stan L. Rev. 857; reprinted in (1984) Sec. L. Rev. 257 at 273.

10. J. Cottrell, "Insider Dealing in the United States - III: The De-Regulation Issue" (1986) 136 New L.J. 150 at 152.

11. Supra, note 2 at 94-95.

12. See Cottrell, supra, note 10 at 151.

13. Ibid.

14. H. Wu, "Corporate Insider Trading in the Stock Market 1957-61" (1965) 2 National Bank Rev. 373 quoted in J. Cottrell, "Insider Dealing in the United States - III: The De-Regulation Issue (1986) 136 New L.J. 150 at 151.

15. Wu, ibid. at 385.

16. Ibid. at 378, 385.

17. Supra, note 2 at 101-104.

18. M.P. Dooley, "Enforcement of Insider Trading Restrictions" (1980) 66 Va. L. Rev. 1.

19. Ibid. at 3.

20. Ibid. at 3.

21. Ibid. at 4.

22. Ibid. at 5.

23. Ibid. at 30.

24. Supra, note 2 at 102.

25. Ibid.

26. See Cottrell, supra, note 10 at 152.

27. Ibid.

28. See Dooley, supra, note 18 at 33.

29. Ibid. at 34.

30. Ibid.

31. See Carlton and Fischel, supra, note 9.

32. Ibid. at 279.

33. Ibid.

34. Ibid. at 261.

35. D.R. Fischel, "Insider Trading and Investment Analysts: An Economic Analysis of Dirks v. Securities and Exchange Commission (1984) 12 Hofstra L. Rev. 127.

36. Ibid. at 129.

37. Ibid.

38. H. Wu, "An Economist Looks at Section 16 of the Securities Exchange Act of 1934" (1968) 68 Colum. L. Rev. 260, as quoted in H. Heller "Fairness Versus Economic Theory" (1982) 37 Bus. Law. 517, at 517, note 4.

39. See Heller, supra, note 38 at 517.

40. Schotland, "Unsafe at Any Price: A Reply to Manne", in "Insider Trading and the Stock Market" (1967) 57 Va. L. Rev. 1425 at 1440-42.

41. See Fischel, supra, note 9 at 281.

42. Ibid. at 261.

43. See Cottrell, supra, note 10 at 151.

44. C.P. Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry" (1977) 29 Stan. L. Rev. 1031, at 1035.

45. H. Heller, "Chiarella, SEC Rule 14-3 and Dirks: 'Fairness' versus Efficiency" (1982) 37 Bus. Law. 517 at 524.

46. Ibid. at 526.

47. Ibid. at 525, 526.

48. See Saari, supra, note 44 at 1032.

49. Report of the Attorney General's Committee on Securities Legislation In Ontario (Toronto: Queen's Printer, 1965) (Chair: J.R. Kimber).

50. Ibid. at 7.

51. See Fischel, supra, note 35 at 129.

52. Ibid. at 129.

53. Ibid. at 130.

54. Ibid. at 142.

55. Ibid.

56. Ibid.

57. See Heller, supra, note 45 at 529, 530.

58. See Fischel, supra, note 35 at 145.

59. Ibid. at 145, note 47.
As Fischel comments:
"The materiality requirement prohibits trading based on "important" information such as knowledge of an impending merger. It does not prohibit whenever there is asymmetric information. Nor does it prohibit a decision not to trade based on asymmetric information, no matter how "material"."

60. See Fischel, supra, note 35 at 146.

61. Ibid.

62. B. Nussbaum, "Insider Trading: Backlash is the Biggest Danger" Bus. Week (23 June 1986) 34.

63. 15 USC, para. 78f(d); l(b)(3); m(o); 0.3(k)(l) L; 5(6).

64. 15 USC, para. 78k(a); j(b) 1964.

65. See Nussbaum, supra, at 34.

66. S. Solinga, "A Proposed New Regime of Insider Trading Regulation" (1986) 14 Sec. Reg. L.J. 106.

67. See Nussbaum, supra, note 62 at 34.

68. Ibid.

69. Ibid.

70. A. Bianco, V. Cahan, "It's War on Insider Trading" Bus. Week (26 May 1986) 38.

71. Ibid.

72. Ibid.

73. A. Bianco, "Wall Street's Frantic Push to Clean Up Its Act" Bus. Week (9 June 1986) 82.

74. See Dooley, supra, note 18 at 44-45.

75. See Bianco, supra, note 73 at 82.

76. J.M. Laderman, "The Epidemic of Insider Trading" Bus. Week (29 April 1985) 79.

77. See Bianco, supra, note 73 at 82.

78. Ibid.

79. S. Weiss, "Insider Trading: The Limits of Self-Policing" Bus. Week (23 June 1986) 46.

80. Ibid.

81. W.B. Glaberson, "The Body Count Climbs In the Levine Case" Bus. Week (14 June 1986) 25.

82. V. Brudney, "Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws" (1979) 93 Harv. L. Rev. 353.

83. Ibid. at 322.

84. See Beck, supra, note 4 at 394.

85. 401 F.2d 833 (2d Circ. 1968), cert. denied, 394 U.S. 976 (1969).

86. See Brudney, supra, note 82 at 353.

87. Ibid.

88. 40 S.E.C. 907 (1961) at 912.

89. See Beck, supra, note 4 at 394.

90. See Brudney, supra, note 82 at 346.

91. Ibid. at 354.

92. Ibid. at 357.

93. _Ibid._ at 360.

94. See Beck, _supra_, note 4 at 396.

95. _Ibid._

96. See Solinga, _supra_, note 66 at 105.

97. 103 S. Ct. 3255 (1983) at 3266.

98. See Brudney, _supra_, note 82 at 348.

99. _Ibid._ at 376.

100. See Beck, _supra_, note 4 at 399-400.

101. _Ibid._ at 400.

CHAPTER VI

THE REGULATION OF INSIDER TRADING IN ONTARIO

(a) INTRODUCTION

Regulation of insider trading in Ontario, as in most of Canada, is primarily by statute. Such legislation evolved to supplant a line of English case law which declared that a director (i.e. the traditional insider) would not in ordinary circumstances owe a fiduciary duty to shareholders. This view, originating with Percival v. Wright (1902)[1] was condoned and affirmed in the present day by Berger, J. of the B.C. Supreme Court in Roberts v. Pelling (1982)[2]. Further, the B.C. Court noted that at common law no such fiduciary obligation existed as between shareholders.[3] Thus, investors could not found liability, at least as against the issuer's directors and officers, upon a fiduciary relationship. Legislative remedy was necessary.

In the United States, in contrast, common law development recognized the existence of a fiduciary relationship between corporate insiders, in cases such as Strong v. Repide.[4] However, insider trading regulation has, of course, proceeded essentially from statute, primarily the Securities Exchange Act of 1934, as reviewed above.

(b) LEGISLATION IN ONTARIO

In Ontario, the governing statute regulating inter alia, insider trading is the Securities Act (hereinafter the "OSA") proclaimed August 1, 1981.[5] The present Act is the most recent result of a series of amendments and revisions of insider trading provisions founded upon the seminal securities legislation of 1966,[6] which resulted from the recommendations of the 1965 Kimber Report.[7]

Part XVII of the OSA governs insider trading, and contains provisions establishing a continuous disclosure system for "reporting issuers" in Ontario. "Reporting issuer" is defined in the OSA in s.1(1)38 as follows:

> "reporting issuer" means an issuer,
>
> i. that has issued voting securities on or after the 1st day of May, 1967 in respect of which a prospectus was filed and a receipt therefor obtained under a predecessor of this Act or in respect of which a securities exchange take-over bid circular was filed under a predecessor of this Act.
>
> ii. that has filed a prospectus and obtained a receipt therefor under this Act or that has filed a securities exchange take-over bid circular under this Act.
>
> iii. any of whose securities have been at any time since the 15th day of September, 1979 listed and posted for trading on any stock exchange in Ontario recognized by the Commission, regardless of when such listing and posting for trading commenced,
>
> iv. to which the <u>Business Corporations Act</u> applies and which, for the purposes of that Act, is offering its securities to the public, or
>
> v. that is the company whose existence continues following the exchange of securities of a company by or for the account of such company with another company or the holders of the securities of that other company in connection with,
>
> (a) a statutory amalgamation or arrangement; or
>
> (b) a statutory procedure under which one company takes title to the assets of the company that in turn loses its existence by operation of law, or under which the existing companies merge into a new company,
>
> where one of the amalgamating or merged companies or the continuing company has been a reporting issuer for at least twelve months.

The significance of becoming a reporting issuer, i.e. a capital market user that is permitted special access to Ontario capital markets, is that unlike those not so qualified,

> "reporting issuers in good standing may sell their securities in certain circumstances without a prospectus, such as on a private placement basis, and such securities, subject to hold periods in some cases, may be resold by such purchasers into the secondary market without the need for a further prospectus. . . ."[8]

The filing of a base disclosure document (e.g. prospectus) setting out all material facts regarding the issuer's affairs qualifies it as a reporting issuer, which subsequently must comply with part XVII's continuous disclosure obligations. While the particulars of the timely and periodic disclosure obligations in the OSA are outside the scope of this thesis, Section 74, wherein those obligations are defined, is one foundation of the sturdy partnership formed with Section 75, which provides for prohibitions against persons illegally trading on material inside information.

Together these sections provide protection of what one commentator has noted as "the integrity of the capital markets by ensuring fairness and equality of access to material information upon which investment decisions are based. . ."[9] That these Sections act in concert to this end has received approval from the Ontario Securities Commission, which asserted the legislated objective to be that "all investors should have an equal opportunity to consider all material facts and changes in reaching investment decisions."[10] Thus, there is imposed on such issuers by these disclosure rules the duty to equitably deal with investors so that they may "trade with confidence that others do not possess meaningful material information about an issuer that gives them an unfair advantage in the market place."[11]

(c) SECTION 75 AND REGULATIONS OF INSIDER TRADING: THE GENERAL STATUTORY SCHEME

Initially, one must turn to this Section of the OSA to understand the present tenor of insider trading proscription in Ontario.

> 75(1) Trading where undisclosed change. - No person or company in a special relationship with a reporting issuer shall,
>
> (a) purchase or sell securities of the reporting issuer with the knowledge of a material fact or material change in the affairs of the reporting issuer that he or it knew or ought reasonably to have known had not been generally disclosed; or
>
> (b) inform, other than in the necessary course of business, another person or company about a fact or change which he knows is a material fact or

material change before the material fact or material change has been generally disclosed.

(2) Exception. - No purchaser or vendor shall be found to have contravened clause (1)(a) if such purchaser or vendor proves that he did not make use of knowledge of the material fact or material change in purchasing or selling the securities.

(3) Interpretation. - For the purposes of this section, a person or company is in a special relationship with a reporting issuer where;

(a) the person or company is an insider or an affiliate of the reporting issuer;

(b) the person is a director, officer or employee of the reporting issuer or of a company that is an insider or an affiliate of the reporting issuer;

(c) the person or company has engaged, is engaging in or proposes to engage in any business or professional activities with or on behalf of the reporting issuer and thereby has acquired knowledge of the material fact or material change; or

(d) the person or company is an associate of the reporting issuer or of any person or company referred to in clause (a), (b) or (c). 1978, c.47, s.75.

Section 75 imports a number of important terms upon which liability will be based, should the transactions under scrutiny fall within the definitions of those terms. Before specifically considering these terms, the overall impact of Section 75 has been succinctly stated as prohibiting two matters:

> "first, special relationship persons may not buy or sell securities of the reporting issuer with knowledge of any undisclosed material fact or material change; second, such persons are prohibited from passing on such information ("tipping") to other people other than in the necessary course of business."[12]

In general then, Section 75 is seen to prohibit "persons likely to be in a preferential position with respect to material corporate information concerning an issuer (and therefore possibly in a unique position to exploit information in the securities of the issuer) from trading to the disadvantage of other investors or potential investors."[13]

In concert with Section 75 is Section 131 of the OSA which subjects to potential civil liability, for any wrongful trading, a person or company in a special relationship with a reporting issuer:

> 131.(1) Liability of person or company in special relationship with a reporting issuer where material fact or change undisclosed. - Every person or company in a special relationship with a reporting issuer who sells the securities of the reporting issuer with knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed and every person or company in a special relationship with a reporting issuer who, directly or indirectly, other than in the necessary course of business, communicates knowledge of the material fact or material change to another person or company who thereafter sells securities of the reporting issuer is liable to compensate the purchaser of the securities for damages as a result of the trade unless,
>
> (a) the person or company in the special relationship with the reporting issuer had reasonable grounds to believe that the material fact or material change had been generally disclosed;
>
> (b) the material fact or material change was known or ought reasonably to have been known to the purchaser; or
>
> (c) the person or company in the special relationship with the reporting issuer proves that he or it did not make use of the knowledge of the material fact or material change in selling the securities or in communicating knowledge of the material fact or material change, as the case may be.

Section 131(2) applies the same prohibitions as above to purchasers of securities, while Section 131(3) covers access to information concerning mutual fund investment programs or portfolios. After covering details of accountability for gain by such insiders to the issuer, and measure of damages,[14] s. 131 sets out the definition of "special relationship" in subsection 7:

> (7) Interpretation. - For the purpose of this section, a person or company is in a special relationship with a reporting issuer where,
>
> (a) the person or company is an insider or an affiliate of the reporting issuer;
>
> (b) the person is a director, officer or employee of the reporting issuer or of a company that is an insider or an affiliate of the reporting issuer;
>
> (c) the person or company has engaged, is engaging in or proposes to engage in any business or professional activities with or on behalf of the reporting issuer

> and thereby has acquired knowledge of the material fact or material change; or
>
> (d) the person or company is an associate of the reporting issuer or of any person or company referred to in clause (a), (b) or (c). 1978, c.47, s.131(6, 7).

This same definition is found in Section 75(3). Significantly, the persons embraced by the term "special relationship" are a wider group than that found in the definition of "insider" pursuant to s. 1(1)17. of the OSA:

> 'insider' or 'insider of a reporting issuer' means,
>
> i. every director or senior officer of a reporting issuer,
>
> ii. every director or senior officer of a company that is itself an insider or subsidiary of a reporting issuer,
>
> iii. any person or company who beneficially owns, directly or indirectly, voting securities of a reporting issuer or who exercises control or direction over voting securities of a reporting issuer or a combination of both carrying more than 10 per cent of the voting rights attached to all voting securities of the reporting issuer for the time being outstanding other than voting securities held by the person or company as underwriter in the course of a distribution, and
>
> iv. a reporting issuer where it has purchased, redeemed or other acquired any of its securities, for so long as it holds any of its securities;

This "insider" definition is referable to the traditional insiders of prior, legislative prohibition and case law developed from the recommendations of the Ontario Kimber Report[15], and is included in s.75(3).

In embracing then this wider group, s. 131(7)(c) is noteworthy as it draws within insider trading prohibitions persons whose business or other dealings with the issuer give them confidential information. As has been commented, this particular group, under the <u>Canadian Business Corporations Act</u> for example, is only partially drawn into proscribed insider trading "by extending civil liability to persons employed or retained by the company."[16]

However, it has also been noted by the same commentators that while s. 131(1) and (2) of the OSA covers "(p)ersons who do the tipping off (tippors) and certain associated persons who derive benefit and advantage from a tip", the "class of persons known as tippees - that is, persons who are 'tipped off' about a confidential fact with knowledge of its source" are not so covered.[17] (That limitation is a significant one, as will be discussed later in relation to a recent decision of the Ontario Securities Commission in Barbara Danuke (1981).)

(d) SECTION 75 AND ENFORCEMENT OF INSIDER TRADING PROHIBITIONS

Before reviewing the specific definitional elements contained within Section 75 upon which liability is founded, it is instructive to note that in contrast to prior securities acts wherein the sanction against insider trading was couched in terms of a statutory cause of action for damages,[18] Section 75 offences are enforced through penal sanction, pursuant to s. 118 of the OSA. This section provides *inter alia* for substantial fines to companies, and fines and/or imprisonment for individuals found guilty upon summary conviction of a Section 75 offence.

The civil action sanction is preserved under s. 131.

In either case, it is not necessary for the Crown or plaintiff (as the case may be) to prove that the special relationship person who illegally traded "made use of" the confidential information. Prior to the present Act, the 1966 Ontario legislation in former s. 113(1) made liable any insider "who, in connection with a transaction relating to the capital securities of the corporation, makes use of any specific confidential information for his own benefit or advantage that, if generally known, might reasonably be expected to affect materially the value of such securities. . ."

A decision by the Ontario Court of Appeal[19] gave a restrictive interpretation to the requirement of "makes use of" and determined that such was not met when defendants in the particular case were not influenced to trade or to shape the transaction in a particular way by what information they knew (in the facts of the case, information of an impending merger). As noted by a commentator on the case,[20] this particular emphasis set too narrow a view of "making use of"; the defendants could have been argued to have done so by buying a person's shares without disclosing information of the impending merger so that the sale would not act to upset such negotiations.

The Court of Appeal in effect made the "makes use of" requirement a defence, i.e. in requiring only that the plaintiff show that the insider had material inside information, and then traded in shares with a person who did not have such information, the onus then shifted to the defendant to show the information was not a factor determinative of his action. Sections 75 and 131 create liability now without the necessity of showing the defendant "made use of" the information. Rather, the "making use of" factor has been retained, but as a statutory defence - the defendant is exonerated if he can prove he did not make use of the alleged material information. (See Section 75(2)). It is important to note that the defence of Section 75(2) is available to vendors and purchasers under Section 75(1)(a), but not to informers under Section 75(1)(b).

Due to the similarity of s. 75 to s. 113(1) of the former Securities Act, a recent case from Alberta considering s. 112 of the then Alberta Securities Act[21] (in all material respects the same as former s. 113(1) in Ontario), is noteworthy for the views of the Judge at trial.[22] The facts as succinctly stated in the headnote of the Alberta Court of Appeal judgment were as follows:

> "The respondent, C, was the president of the respondent N Ltd. B was the chief executive officer of H Ltd. The two companies, which were both in the natural resources business, decided to merge their operations, H Ltd. buying all producing properties from N Ltd. N Ltd. became entitled to purchase certain shares from H Ltd. at a specified price. C also acquired shares of H Ltd. and became its employee. In 1975, B and C had a falling out and C resigned from H Ltd. Several actions were commenced, but were settled. The minutes of settlement required B to pay N Ltd. a stated sum of money, N Ltd. was to surrender its rights under the stock option agreement and N Ltd. and C were to sell their shares to B. Before the minutes of settlement were signed, B negotiated with another company for the sale of all H Ltd.'s shares. He

> did not reveal this to C. B then died and N Ltd. and C brought this action against B's executors for damages. They were successful at trial."

In considering whether or not "B" (Bodrug) "made use of" any specific confidential information, the Court found that it was incumbent upon the defendant to prove that the information in question was not one of the factors inducing him to enter into the transaction.[23] In finding against Bodrug, the Court quoted with approval a recognized commentator's formulation of the applicable test:

> "One does not have to find a single or even principal motive for the transaction; rather, one asks whether the knowledge of the information was one out of possibly many factors in assisting or influencing the insider."[24]

(It should be noted that the "made use of" requirement has been now completely repealed from the Alberta Securities Act, s. 171.)[24A]

(e) SECTION 75 - THE SPECIAL RELATIONSHIP AND SPECIFIC DEFINITIONAL ELEMENTS

As discussed, Section 75(3) and Section 131(7) define "special relationship" persons. Within the definition are included affiliates and associates of any person or company that otherwise is a special relationship person. The effect, as has been noted, is "that many unsuspecting special relationships exist." For example, the spouse of a partner of a law firm approached though not necessarily engaged, by an issuer to ~~act in~~ connection with a takeover proposal may be a special relationship person as regards the issuer, as indeed, all of the partners of such partner would be if they acquired knowledge of material facts and changes.[25]

This account might be taken to suggest that the special relationship criteria are drawn broadly enough to regulate insider trading abuses, despite the precondition that the person trading must be related to the issuer through traditional insider links, as expressed in Section 75(3). However, just as the development of present case-law in the U.S. (vide Chiarella and Dirks) has emphasized the need to regulate insider trading among those not so-linked (resulting in the collateral development of insider liability based on, for example, the misappropriation theory and the relation of employee to employer regarding misuse of confidential information), so too it is argued by commentators in Canada that the scope of special relationship persons should broaden to regulate persons now "outsiders" under the O.S.A.

Victor Alboini asserts that the foundation of Part XVII is "equality of information" in the present market place. On that basis, he argues that the extension of the scope of special relationship persons is justified and expected to grow in the future:

> "It might reasonably be extended to include certain outsiders (i.e. any person whether or not related to the issuer) who knowingly buys or sells securities of a reporting issuer with the knowledge of a material fact or material change in the affairs of a reporting issuer, where he knows that the information had not been generally disclosed.
>
> In effect, therefore, outsiders, with no connection with the issuer through traditional insider links, would be liable if they knew (not ought reasonably to have known) they had material undisclosed information and they purposely traded with it. Such growth is reasonable, for if equality of information is the touchstone, the source of the information or the relationship of the person trading or tipping to the issuer should not be determinative of liability as is presently the case."[26]

Two factors present themselves in Alboini's argument for extension of insider liability: that the rationale of equality of information is the preferred justification, as evidenced by the continuous disclosure aims of the O.S.A.; and that this extension to "outsiders" would be tempered with a direct knowledge requirement on the part of outsiders as regards the receiving of, and trading upon material information to their advantage.

To be sure, this extension of insider liability to such outsiders can be justified if one adopts, as does Alboini, the rationale for regulation of "equality of information". On the basis of that rationale, neither the source of the information nor the relationship of the person trading or tipping to the issuer should be a precondition to liability. Under present OSA regulation, such preconditions are the case.

Discussion earlier focused upon the different rationales given, for either extending or delimiting insider trading regulation.[27] In Ontario, recent comments by the Ontario Securities Commission (hereinafter "OSC") clearly indicates the OSC's preference for the "equality of information" view, and also its concerns over the types of trading activity not caught ~~by~~ Section 75 as presently drafted. In Joseph Burnett (1983),[28] the allegations by Commission staff were inter alia that Burnett, while in a special relationship with Crown Trust, violated Section 75(1)(b) of the OSA by informing certain persons of a material change in the affairs of Crown Trust.[29] An agreement was entered into August 24, 1982, between Burnett and a group of investors, Cohen and Ellen, for the sale to Burnett of a large number of common shares of Crown Trust, amounting to 32% of the outstanding common shares. Immediately prior to completion of the agreement, a temporary "cease-trade" order was issued by the Commission relating to the Crown Trust shares, pursuant to s.123(3) of the OSA. Upon receiving notice of the order, the parties to the agreement, with BNA Realty Inc. ("BNA"), entered into an escrow agreement dated September 9, 1982. The shares which were the subject of the agreement were deposited in trust with counsel for the purchaser, the price to be paid deposited with counsel for the vendor. Burnett the apparent purchaser recited in the escrow agreement that:

> ". . . it had been the intention throughout that the actual purchaser of the Crown Trust shares would be BNA Realty Ltd."

Further reciting that all the issued shares of BNA were owned by one Theodore Burnett (brother to Burnett) and that "BNA is not an associate of mine within the meaning of the Securities Act," the escrow agreement also provided that BNA had the right at any time to sell the Crown Trust shares to a third party.[30] On October 7, 1982, the escrow shares were sold to Greymac Credit Corporation, at a substantial price. The Commission held that despite formalities of agreement to the contrary, BNA was not the beneficial owner of the shares in Crown Trust, and that "Burnett masterminded the acquisition of the Crown Trust shares . . . and that Burnett directed BNA's affairs as if he controlled BNA." The Commission agreed to look through the form of Burnett's relationship to BNA, finding that Burnett "simply used BNA as an instrument to acquire a significant position in Crown Trust."[31]

The allegation of the breach of Section 75 claimed that Burnett, in a special relationship with Crown Trust, during the course of a luncheon on August 24, 1982, advised two business acquaintances of his intent to acquire an interest in Crown Trust. His friends accordingly purchased shares in Crown Trust on August 25th and 27th, confirmation of Burnett's intentions having been made.[32]

For the Commission to found liability it had to be shown that:

(a) Burnett was in a special relationship with Crown Trust at the material times; and

(b) the information communicated by Burnett constituted "a material change in the affairs" of Crown Trust pursuant to Section 75(1)(a).

Commission staff argued Burnett was in a special relationship with Crown Trust by becoming an insider, upon two grounds. First, that Burnett beneficially owned or exercised control or direction over voting securities of Crown Trust carrying more than 10% of the voting rights attached to all voting securities of Crown Trust outstanding. This was alleged to arise from the August 24th agreement between Burnett and Cohen and Ellen.

Secondly, the staff argued Burnett became an insider by acquiring more than 10% of the voting shares of Crown Trust, and that as a director of BNA, Burnett was deemed to be an insider of Crown Trust for the six months previous to the time BNA became such.[33]

The Commission could not accept either argument for:

> "both submissions require a finding, either that Burnett beneficially owned the Cohen and Ellen shares, or that BNA beneficially owned (them). In our view, beneficial ownership of the . . . shares did not pass to either Burnett or to BNA. This block of shares was put into escrow. Although by the terms of the escrow certain rights were conferred upon BNA

> concerning the . . . shares such rights fell short of constituting beneficial ownership."[33A]

Further, as regarded the alleged "tipping" by Burnett of his acquaintances, the Commission found it was done "at a time prior to his execution of the agreement with Cohen and Ellen related vendors and therefore, even if Burnett did become an insider of Crown Trust by virtue of the agreement concerning Cohen and Ellen block, he acquired this status after he "tipped" his business acquaintances."[34]

Clearly here the shortcomings of Section 75 gave Burnett a technical victory. However, the Commission firmly stated its preferences in regard to such activity and at the same time affirmed its view of the proper rationale for insider trading regulation:

> "We do, however, wish to comment that, definitions of "material change" and "special relationship" aside, the principle of equality of information in the marketplace obligates any person or company which intends to acquire a significant interest in a company, in circumstances where possession of such information puts the person at an advantage over other participants in the marketplace, not to inform others of this intention, except in the necessary course of business. Although we have concluded that Burnett was not technically in a special relationship with Crown Trust, we wish to express our strong disapproval of Burnett's conduct in informing three of his business acquaintances of his intention concerning Crown Trust, information which enabled these business acquaintances to acquire shares of Crown Trust, and apparently subsequently dispose of the shares at a profit."[34A]

Admonition by the Commission, as strongly put here as it was, could not overcome the technical limitations of Section 75, nor amount to a legal prohibition of what surely was insider tipping of significant nature and effect. Nevertheless, in its forthright language, the Commission could be seen to be serving notice of pursuing policies on the basis of equality of information in the market place.

Another case before the Commission further illustrated the limitations of Section 75 and the "special relationship" prohibition. In Barbara Danuke (1981)[35] the facts involved Danuke as a securities salesperson and as such a "registrant" under the OSA (at that time, the 1978 Securities Act), allowing her to deal in securities.

Danuke on May 12, 1981 became aware through a conversation with a Toronto-Dominion Bank ("T.D.") officer, of the T.D.'s imminent announcement of its intention to offer to purchase all assets of the T.D. Realty Investments ("TDRI"). This would be done by acquiring all outstanding TDRI trust units, at $24.00 a unit. T.D.'s intention, at the time of the conversation, had not been publicly disclosed.

Danuke, immediately after this conversation, relayed the same information to three persons, MacDonald, Scott and Seitz, fellow employees and registrants in the same investment company. Each of the four purchased sizable trust units of TDRI for their personal accounts and those of their clients on the Toronto Stock Exchange on the same day, May 12, 1981. T.D. announced its intentions publicly after the close of the market on that day.[36]

The allegation of the Commission's staff was directed at Danuke's conduct and that of her colleagues as registrants:

> "The conduct of Danuke, MacDonald, Scott and Seitz . . . was contrary to the public interest and fell below the standard of conduct that may reasonably be expected of registrants."[37]

The Commission discussed the registrant's characterization of the information received from the T.D. officer as mere "rumour", and found that the information given to Danuke was clearly instrumental in the subsequent purchases of TDRI units by them.[38]

In finding that Danuke and her colleagues took advantage of insider information, the Commission could not censure them as "tippees" under Section 75 for that section could not proscribe the particular dealings the registrants had made upon the information received from the T.D. officer. Outside the definition of "special relationship", as regarded the issuer, the T.D., Danuke and the other registrants could not be effectively disciplined for improper insider trading, which was the gravamen of their offence. More obliquely, they were disciplined on the more general basis of their duty owned as registrants:

> "It is the concept of honesty and integrity, of fair dealing as between classes of investors, which is the issue here. It is in the public interest that registrants conduct themselves in accordance with these precepts and not take advantage of inside information.
>
> It is the Commission's view that all registrants ought to understand that they have a duty not to attempt to profit, directly or indirectly, through the use of inside information that they believe is confidential and know or should know came from a person having a special relationship with the source of the information."[39]

The "special relationship" which the Commission found was that between the T.D. officer and the T.D. The information regarding TDRI was clearly a "material fact," and its announcement had a "significant effect on the market price of the units." The information was clearly "inside information" for it was not generally disclosed until announced later on the 12th of May.[40]

As such, the T.D. officer pursuant to Section 75(3) was in a "special relationship" with the T.D. and was prohibited from informing anyone, except in the ordinary course of business, of the T.D.'s proposal regarding TDRI.

Despite the present lack of effective prohibition under Section 75 of such trading as Danuke made, Stanley Beck has pointed out the importance of the OSC clarifying "that it will discipline a registrant who uses or communicates material, non-public information even though such registrant is not in a "special relationship" under the OSA."[41]

It is submitted that the need for reform of Section 75 to embrace tippees is evident, and no longer need be a matter of controversy. There are already in place both federal and provincial enactments which proscribe insider trading as regards tippees, which offer legislative precedent for the OSA.

In Section 125(1) of the Canada Business Corporation Act,[42] the definition of "insider" proscribes, in subsection (f) the tippee's trading on insider information:

> 125(1) "Insider" defined. - In this section "insider" means, with respect to a corporation,
>
> (a) the corporation;
>
> (b) an affiliate of the corporation;

(c) a director or an officer of the corporation;

(d) a person who beneficially owns more than ten per cent of the shares of the corporation or who exercises control or direction over more than ten per cent of the votes attached to the shares of the corporation;

(e) a person employed or retained by the corporation; and

(f) a person who receives specific information from a person described in this subsection or in subsection (3), including a person described in this paragraph, and who has knowledge that the person giving the information is a person described in this subsection or in subsection (3), including a person described in this paragraph.

More recently, the new Quebec Securities Act[43] also proscribes such trading, in Section 226, read with Section 189, recently amended to broaden insider liability:

> 226. Every person who carries out a transaction contrary to section 187, 189 or 190 is responsible for the harm suffered by the other part to the transaction.
>
> 189. The prohibitions set out in sections 187 and 188 also apply to the following persons:
>
> (1) the senior executives referred to in section 94 and 95;
>
> (2) affiliates of the reporting issuer;
>
> (3) the person responsible for the management of a mutual fund or an unincorporated mutual fund, for giving it advice on financial matters or for distributing its shares or units, and any person who is an insider of such a person;
>
> (4) every person who has acquired privileged information in the course of his relations with or of working for the reporting issuer, as a result of that person's functions or of his engaging in business or professional activities;
>
> (5) every person having privileged information that, to his knowledge, was disclosed by an insider or a person referred to in this section;
>
> (6) every person who has acquired privileged information that he knows to be such concerning a reporting issuer;
>
> (7) every person who is an associate of the reporting issuer, of an insider of the latter or of a person contemplated in this section.

(f) SECTION 75: THE "SPECIAL RELATIONSHIP" AND THE NON-TRADITIONAL INSIDER SITUATION

To gauge the effectiveness of, and limitations to Section 75 in non-traditional insider activity, it is useful to draw comparative examples from the U.S. experience. Whereas in Ontario the bulk of insider activity appears to relate to more traditional insiders, such activity undoubtedly also involves those non-traditional or "outsider" traders of which we have few examples in the case law. Clearly, we can derive from American examples the problems the present or amended Ontario legislation can be expected to deal with.

Our review should start with the Chiarella[44] and Dirks[45] fact situations, and the application of Section 75 to them. In Chiarella, the printer defendant would not be an insider under the OSA, for he would not be in a special relationship with a reporting issuer pursuant to Section 75(3). Further, Chiarella's employer engaged in business activities with the offeror (pursuant to Section 75(3)(c), but it was the offeree who was the reporting issuer whose shares were purchased. As has been noted, "(e)ven if the employer was in a special relationship with the offeree, and its associates therefore included by Section 75(3)(d), the definition of associate in Section 1(1)2 does not include an employee . . ."[46] Chiarella avoids liability once more.

As for Dirks, the same commentator has made persuasive argument for liability, but argument it remains, so that no clear picture of liability emerges under the OSA:

> "Dirks was a tipper and s. 75(1)(b) makes it an offence to tip and s. 131(1) imposes civil liability on a tipper, if in a special relationship, when his tippee trades. But was Dirks in a special relationship with Equity Funding? The only possibility would be to argue that Dirks "engaged in . . . any business or professional activities with or on behalf of the reporting issuer" within s. 75(3)(c). The case could be made that Dirks, as a securities analyst, was engaging in a professional activity with Equity Funding when he investigated its affairs. That could be said to be the case every time an analyst deals with a

> listed company, even though the company has not retained him. It might also be argued that the activity is "on behalf of" the reporting issuer as it is to an issuer's advantage to be open to analysts, even if the ultimate report is not always to its liking. The case is far from clear (some contractual relationship may be required) but it is certainly arguable."[47]

That commentator also reviewed the case of <u>Materia</u>[48] where, like Chiarella, a financial printer purchased, but did not sell, shares based on information obtained from his work with respect to a takeover bid. As discussed above,[49] the defendant was found liable on the misappropriation theory for violating his duty to his employer - but no liability under the OSA arises.

In the case of a word processor in a law firm who used confidential information therefrom in respect to takeover bids[50] (and was found liable for breaching his duty to his employer), there again would be no liability under the OSA. "The law firm is in a special relationship with the client under Section 75(3)(c), as are its associates under Section 75(3)(d). Associate (OSA, s.1(1)2) is defined to include partners but does not include employees and the secretary is therefore free of liability. In any event, the 'reporting issuer' would be the offeree, not the offeror who retained the law firm."[51]

Further examples have been analyzed with the same effects[52] but the end result is the clear "need for major amendments to the OSA".[53] The nature of those suggested amendments, and the rationale will be discussed in the concluding Chapter - but the limitations of Section 75 to the trading of non-traditional insiders are evident.

(g) <u>SECTION 75: CONSIDERATION OF OTHER CONSTITUENT ELEMENTS</u>

(i) <u>"Material facts" and "material changes"</u>

Both these elements appear in Section 75 ("Material change" alone appears in Section 74). Dealing with each in the order they are defined in the OSA:

"Material Change" is defined in section 1(1)21 as follows:

> "material change" where used in relation to the affairs of an issuer means a change in the business operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer and includes a decision to implement such a change made by the board of directors of the issuer or by senior management of the issuer who believes that confirmation of the decision by the board of directors is probable.

"Material Fact" is defined in Section 1(1)22 as follows:

> "material fact" where used in relation to securities issued or proposed to be issued means a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities.

As a material change is only such when it "would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer" clearly materiality is closely aligned to the investment decision process:

> "The reference to 'any' of its securities means that the issuer must consider the effect on each class of securities, including those that may be the most volatile of its issued securities and most subject to change. The effect of focusing on price or value of the securities as the appropriate test may be to exclude, as material changes, matters that may influence, and may therefore be material to, an investor in making an investment decision but do not have the probable effect of significantly altering market price or value of any securities of the issuer."[54]

The second part to the definition of material change deals with proposed changes, or decisions which might effect a material change but at a future time. It is the decision itself, not the future actual change, which is reportable. "Under this part of the definition, a proposed change can only become a material change when the board of directors decides to implement it, or, at the earliest, when senior management decides to implement it and believes confirmation by the board of directors is probable."[55]

The Ontario Securities Commission in its reasons in <u>Joseph Burnett</u> noted:

> "An intention by a person or company to do something, which once implemented would constitute a material change in the

> affairs of the reporting issuer, but which at the time the intention is formed, for reasons beyond the control of the person or company is still not capable of achievement, is not ordinarily a material change in the affairs of the issuer."[56]

The concept of "material change" should be distinguished from "material fact". Undisclosed material facts concerning a reporting issuer may not require timely disclosure under Section 74, although they do restrict trading under Section 75(1).

In Royal Trustco Ltd., Kenneth Allan White and John Merton Scholes (1981)[57] the Ontario Securities Commission explored this distinction. The facts were that two Royal Trustco Ltd. senior officers were held to have disclosed certain material information to some shareholders, but not to others in an effort to ward off an attempted take-over of Royal Trustco Ltd. by Campeau Corporation. The Commission found as a fact that the officers had told at least one major shareholder, that, because friendly hands secured at least 60% of the shares subject to the takeover, the Campeau bid would not succeed; further that these officers told the same shareholder that the dividends currently paid on the shares, subject of the bid, might well be increased.

Each event, the Commission decided, constituted improper disclosure of material facts.[58] No finding was made that these disclosures were material changes, (or proposed material changes), subject to the timely public disclosure obligation of Section 74.

Similarly, the Commission found in the Danuke case[59] that the information which the Toronto-Dominion Bank officer passed regarding that Bank's intended take-over bid of TDRI units was a material fact, and as such insider information pursuant to Section 75.

As one commentator has noted, the Royal Trustco case "serve(s) to illustrate the difference between material facts and material changes. While there was no question that the information pertaining to the likely success of the take-over bid was material information for traders of Royal Trustco shares, the information involved an external state of affairs not directly relating to the internal business, operations or capital of Royal Trustco."[60] Hence, a finding of "material fact" was made.

For a "special relationship" person dealing with an issuer, the same commentator noted the importance of whether "material changes" or "material facts" are involved.

> "Probably the most significant difference in the definitions is that the effect on market price or value is referable to any of the securities of the issuer in the definition of "material change", whereas it is referable to particular securities in the definition of "material fact". Therefore, a "special relationship" person, should he be contemplating trading securities of a reporting issuer, need only be concerned about material facts that are referable to securities he is proposing to trade, whereas he must be concerned about all material changes in the business and operations or capital of the reporting issuer whether referable to the securities he is proposing to trade or whether referable to other securities of the reporting issuer."[61]

(ii) The knowledge element and its relation to the disclose or refrain from trading rule

Section 75(1)(a) prohibits any person or company in a special relationship with a reporting issuer from purchasing or selling securities of the reporting issuer with knowledge of a material fact or material change in the affairs of the reporting issuer that he or it knew or ought reasonably to have known had not been generally disclosed.

This two-part requirement as to the state of mind of the special relationship person imposed upon that person the obligation of ascertaining beyond basic enquiry whether material information has been disclosed. To what extent that enquiry must proceed will depend on the status of that person vis-a-vis the reporting issuer, i.e. it can be assumed that a director thereof will have a heavier onus of enquiry than, for example, an affiliate's employee.[62]

An important question arises as to when circumstances will be such that a special relationship person, who becomes aware of undisclosed material information, has no alternative but to refrain from trading in the reporting issuer's securities. The following observations have been made on this issue:

> "If the material information is a material fact, there is no obligation for the reporting issuer to disclose it on a timely basis under s. 74. If the special relationship person cannot cause disclosure by the reporting issuer, he is faced with causing disclosure himself, and this may not be available depending upon his position or relationship with the reporting issuer, and also may not be advisable if he does not have and cannot obtain adequate information concerning the material fact but only has knowledge in a general way that it exists. If disclosure is made, whether generally or privately, to the other party to the trade in an attempt to assume equal information to the parties to the trade so as to avoid liability under s. 75, there is a risk of litigation if the information conveyed is inaccurate or if the reporting issuer is concerned that the information remain confidential. In any event, such disclosure would have to satisfy the "ordinary course of business" test in s. 75(1)(b)."[63]

In Kaiser Resources Ltd. and Robert Stanlake (1981)[64] the Commission applied the prohibition in Section 75(1)(a) to embrace employees in a special relationship with their company from exercising employee stock options previously created. BCRIC Enterprises Ltd. made a take-over bid for all issued and outstanding shares of Kaiser Resources Ltd. The Commission found that certain Kaiser employees exercised stock options to purchase Kaiser shares when there was no doubt of an imminent BCRIC takeover of Kaiser. Finding that each employee was aware of that circumstance and that public announcement of the arrangement would significantly impact on the market price of Kaiser's shares, the Commission held that Section 75(1)(a) applied to a purchase of securities through employee stock arrangement, even though such arrangements had been organized for some time previously for the employees' benefit.[65] (No sanctions were imposed as the employees were given the benefit of the doubt as to their understanding of the parameters of the then newly-enacted Section 75.)

(iii) Section 75: The "Generally Disclosed" Element

In referring to information becoming "generally disclosed" the requirements of Section 75 thereto are not satisfied merely by compliance, for example, with Section 74(1) and (2) (by issuance of a press release or report as the case may be). What is required has been succinctly stated by the Commission in what is known as the National Sea (1976) decision.[66]

> "(A)n insider is not in all cases free to trade as soon as a press release with respect to the specific confidential information is put over the Dow Jones wire. The appropriate standard is a two part one: the information must be disseminated to the trading public and the trading public must have it in its possession for a period of time that will allow it to digest such information given its nature and complexity. There can be no firm rule as to what interval this will normally be. It very much depends upon the nature and complexity of the information, the nature of the market for the stock, the place of the market for the stock, the place of the company's operations and the place of dissemination of the news release. We do feel confident in saying, however, that an insider may not trade with the release of the news as was literally the case here. A safe working rule would be that an insider should wait an minimum of one full trading day after the release of the information before trading."[67]

What is the most noteworthy of the Commission's views is its requirement that there be sufficient time not only for dissemination of the information, but for its proper appreciation by the trading public.

(iv) Section 75(1)(b): Prohibition Against Tipping

Section 75(1)(b) prohibits a person or company in a special relationship from informing another person or company about a fact or change known to the informer to be a material fact or material change before the material fact or material change has been generally disclosed. This prohibition does not apply where a person or company in a special relationship with a reporting issuer informs another person or company of a material fact or material change in the necessary course of business. Whether such information is in the necessary course of business is a question of fact that will depend on the circumstances of each case and that may be less than obvious in some cases.

In the Divisional Court appeal of the Royal Trustco Ltd. case discussed above,[68] the Court affirmed the Commission's findings of disclosed material facts, and held that such facts had been disclosed to the shareholder not "in the ordinary course of business."[69]

As a commentator has noted, the "fact that (the Royal Trustco Ltd. officers) were doing their very best to defend against a takeover bid that they did not believe to be in the best interest of Royal Trustco was not a sufficient purpose to be in the ordinary course of business. This conclusion was reached notwithstanding the fact that the Commission very clearly said in their decision that they effectively had no quarrel with the defensive tactics adopted by Royal Trustco in connection with the Campeau bid."[70] As was further noted, "(p)erhaps disclosure of material facts or material change information to a shareholder, at any time, that clearly gives that shareholder an investment decision advantage, can never be considered to be in the "necessary course of business"."[71]

(h) BREACHES OF SECTION 75: ADMINISTRATIVE REMEDIES

Additional to the penal and civil remedies discussed above, under Section 118 and 131 of the OSA, are the administrative remedies available to the Ontario Securities Commission for abuses of insider trading. These take three forms: Section 122, Order for Compliance; Section 123, Order to Cease Trading and Section 124, Removal of Exemptions.

Section 122: Order for Compliance, reads as follows:

> 122.(1) Order for compliance. - Where it appears to the Commission that any person or company has failed to comply with or is violating any decision or any provision of this Act or the regulations, the Commission may, notwithstanding the imposition of any penalty in respect of such non-compliance or violation and in addition to any other rights it may have, apply

to a judge of the High Court for an order,

(a) directing the person or company to comply with the decision or provision or restraining the person or company from violating the decision or provision; and

(b) directing the directors and senior officers of the person or company to cause the person or company to comply with or to cease violating the decision or provision,

and upon the application the judge may make such order, or such other order as he thinks fit.

Section 123: Order to Cease Trading, states:

123.(1) Order to cease trading. - The Commission may, where in its opinion such action is in the public interest, order, subject to such terms and conditions as it may impose, that trading shall cease in respect of any securities for such period as is specified in the order.

(2) Idem. - The Commission may issue a cease trading order under subsection (1) notwithstanding the delivery of a report to it pursuant to subsection 74(3).

(3) Temporary Order. - No order shall be made under subsection (1) or (2) without a hearing unless in the opinion of the Commission the length of time required for a hearing could be prejudicial to the public interest, in which event the Commission may make a temporary order, which shall not be longer than fifteen days from the date of making thereof, but the order may be extended for such period as the Commission considers necessary where satisfactory information is not provided to the Commission within the fifteen day period. 1978, c. 47, s. 123.

Section 124: Removal of Exemptions, states:

124.(1) Commission's discretion to remove exemptions. - The commission may, where in its opinion such action is in the public interest, order, subject to such terms and conditions as it may impose, that any or all of the exemptions contained in sections 34, 71, 72 and 88 do not apply to the person or company named in the order.

(2) Temporary order and hearing. - No order shall be made under subsection (1) without a hearing unless in the opinion of the Commission the length of time required for a hearing could be prejudicial to the public interest, in which event a temporary order may be made which shall not be for longer than fifteen days from the date of the making thereof unless the hearing is commenced in which case the Commission may extend the order until the hearing is concluded.

(3) Notice. - Notice of a temporary order made under subsection (2) shall be given forthwith together with the notice

of the hearing under subsection (2) to every person or company who in the opinion of the Commission is directly affected thereby. 1978, c. 47, s. 124.

The important exemptions referred to in Section 124(1) relate generally to:

1. exemption of trades registration (Section 34);

2. from filing a prospectus (Sections 71, 72); and

3. exemption of take-over bids, and issuer bids (Section 88).

Two cases of the imposition of these remedies by the Commission serve to illustrate their use.

In the Royal Trustco Ltd. decision, Section 124(1) was used to impose upon the two senior Royal Trustco officers deprivation of exemptions they were otherwise entitled to. The effect was to deny them the right to trade in any securities in Ontario, for the period of the deprivation (60 days for one officer, 30 days for the other).[72]

The consideration of, and ultimate decision not to impose a similar deprivation was made by the Commision in the Frederick Clark case (1981).[73] Reviewing the actions of certain persons with regard to an announced take-over bid by B.C. Resources Investment Corporation ("BCRIC") for all the issued and outstanding shares of Kaiser Resources Ltd., the Commission focused upon trading in options contracts by, inter alia, Clark, prior to the announcement by BCRIC. Evidence appeared to indicate that one Glanville, an employee of Kaiser and therefore in a special relationship with it, had tipped his uncle Clark about the announcement prior to its public disclosure. In reviewing whether to deny to either party Section 34 exemptions, the Commission's majority determined such would not be in the public interest. This was based upon the rather unique factor that B.C. and Ontario's securities regulators had appointed an investigator to review the actions of the two parties. His findings exonerated them of any intentional wrongdoing.[74] As has been noted:

"The conclusions of the Commission both as to Glanville and Clark suggest that a breach of s. 75 requires an intention to manipulate or some kind of fraud, for the offence to exist. Proof of an intent to manipulate the markets or at least affirmative evidence of the absence of such circumstances may well be, therefore, important to establishing a breach of s. 75. In the minority reasons of Knowles and Bray, any such requirement for intention is, however, denied."[75]

Thus, while considering remedial questions, at least the majority of the Commission appeared to add a requirement of specific intent to Section 75. Given the dissenting options to the contrary, it would appear to remain as yet an open question.

(i) CONCLUSION

A review of the statutory scheme of the OSA and the resulting decisions, primarily of the Ontario Securities Commission, indicates that regulation of insider trading in Ontario has proceeded with basic uniformity of purpose to achieve through Section 75 the continuous disclosure ethic sought under Section 74. The rationale for controlling insider trading, both stated and implied, centres upon equality of information in the financial market place. Whether this rationale will support extensions of insider trading prohibitions to the non-traditional insiders or indeed "outsiders" will be canvassed below. However, it is clear that basic legislative amendment of Section 75 is necessary to equip the Commission with wider powers of proscription into trading that involves tippees, and other such traders. Consideration of the extent of such amendment will also appear below.

CHAPTER VI

FOOTNOTES

1. 1902 2 Ch. 421.

2. (1982) 16 B.L.R. 150 (B.C.S.C.).
Despite the B.C. Court's opinion, other jurisdictions have been critical of the purported breadth of the principle in Percival v. Wright, preferring to, for example, limit the Judge's reasoning to the particular facts of the case. The New Zealand Court of Appeal preferred to limit the decision to actions for rescission for non-disclosure, in Coleman v. Myers, 1977 2 N.Z.L.R. 225. In considering the common law position the Court held that in a family company, the directors (on the basis of a fiduciary duty of care owed to its shareholders) might have a general duty to disclose material matters on which they knew that the shareholders being asked to sell their shares were not properly informed.

3. 16 B.L.R. 150 at 153.

4. 213 U.S. 419 (1909).

5. R.S.O. 1980, c. 466, as am. 1984, c. 59.

6. The Securities Act, 1966, S.O. 1966, c. 142.

7. Report of the Attorney General's Committee on Securities Legislation In Ontario (Toronto: Queen's Printer, 1965) (Chair: J.R. Kimber), known as "The Kimber Report".

8. V. Alboini, Securities Law and Practice (Toronto: Carswell, 1984) at 17-2.

9. Ibid.
It should be noted that these provisions however do not attach liability to insider trading for non- reporting issuers, which is a limitation to achieving the "integrity" of such markets. (The Canada Business Corporations Act, for example, does provide for the liability of such non-reporting issuers.)

10. Re McLaughlin and S.B. McLaughlin Associates Ltd. (1981), 14 B.L.R. 46 at 59.

11. Alboini, supra, note 8 at 17-7.

12. Ibid. at 17-29.

13. Ibid.

14. See Section 131(4), and (6) respectively.

15. Supra, note 7, paras. 2.05 through 2.10.

16. T. Hadden, R.E. Forbes and R.L. Simmonds, Canadian Business Organizations Law (Toronto: Butterworths, 1984) at 464, 465 and note 498.

17. Ibid. at 465.

18. Ibid. at 464.

19. Green v. Charterhouse Group of Canada Ltd. (1976) 12 O.R. (2d) 280 (C.A.).

20. F.H. Buckley, "How to Do Things With Inside Information" (1977-78) 2 Can. Bus. L. J. 343 at 353 ff.

21. Securities Act, S.A. 1981 c. S-6.1, as am. S.A. 1981 c. B-15, and 1982, c. 32.

22. NIR-Oil Ltd. v. Bodrug (1983) 23 B.L.R. 52 (Alta. Q.B.); aff'd. (1985) 18 D.L.R. (4th) 609 (Alta. C.A.); leave to appeal refused S.C.C., Nov. 1985.

23. Ibid. at 69 (Alta. Q.B.).

24. Ibid.

24A. Supra, note 21.

25. Alboini, supra, note 8 at 17-30.

26. Ibid.

27. Generally, see CHAPTER V.

28. 6 O.S.C.B. 2751 [September, 1983]

29. Ibid. at 2752.

30. Ibid. at 2753.

31. Ibid. at 2756.

32. Ibid. at 2757.

33. Ibid. at 2758.

33A. Ibid.

34. Ibid.

34A. Ibid. at 2759.

35. 2 O. S.C.B. 31 C [September, 1981].

36. Ibid. at 32C.

37. Ibid. at 33C.

38. Ibid. at 35C and 39C.

39. Ibid. at 40C.

40. Ibid. at 39C.

41. S.M. Beck, "Of Secretaries, Analysts and Printers: Some Reflections on Insider Trading" (1983-84) 8 Can. Bus. L. J. 385 at 403.

42. S.C. 1974-75-76, c. 33, as am. S.C. 1976-77, c. 52, Sched.; 1978-79, cc. 9 and 11; 1980, c. 43; and 1980-82, cc. 47 and 115.

43. S.Q. 1982, c. 48; as am. S.Q. 1982, c. 26; 1983, c. 56 and 1984, c. 41.

44. Chiarella v. United States 100 S. Ct. 1108 (1980).

45. Dirks v. S.E.C. 103 S. Ct. 3255 (1983).

46. Beck, supra, note 41 at 401.

47. Ibid. at 402.

48. S.E.C. v. Materia 745 F. 2d 197 (2d Cir. 1984).

49. See CHAPTER V.

50. S.E.C. v. Madan (D.C.S.N.Y. 1983) 15 B.N.A. Secs. Reg. and Law Rep. 1349

51. Beck, supra, note 41 at 406.

52. Ibid. 404 ff.

53. Ibid. at 408.

54. Alboini, supra, note 8 at 17-8, 17-9.

55. Ibid. at 17.11.

56. 6 O.S.C.B. at 2759.

57. 2 O.S.C.B. 322C [October, 1981].

58. Ibid. at 346C.

59. 2 O.S.C.B. 39C.

60. Alboini, supra, note 8 at 17-14.

61. Ibid. at 17-36.

62. Ibid. at 17-37.

63. Ibid. at 17-38.

64. 1 O.S.C.B. 13C [April, 1981].

65. Ibid. at 19C.

66. Re Harold P. O'Connor, Clarence J. Morrow, William O. Morrow, James B. Morrow, Charles R. MacFadden, Jack B. Estey O.S.C.B. 149 [June, 1976].

67. Ibid. at 174.

68. Re Royal Trustco Ltd. et al. and Ontario Securities Commission (1983) 42 O.R. (2d) 147 (Div. Ct.) and see, supra, note 57.

69. Ibid. at 152 (Div. Ct.).

70. Alboini, supra, note 8 at 17-50.

71. Ibid.

72. 2 O.S.C.B. 322C.

73. 2 O.S.C.B. 443C [November, 1981].

74. Ibid. at 445C.

75. Alboini, supra, note 8 at 17-52.

CHAPTER VII

CONCLUSION

(a) SIGNIFICANCE OF CHIARELLA AND DIRKS WITH RESPECT TO THE EXTENSION OF LIABILITY TO NON-TRADITIONAL INSIDERS

This study has focused on the extension of insider trading liability to non-traditional insiders and the various rationales that have evolved to support such an extension. The issue of what particular categories of "outsiders" should be subject to the duty to disclose or refrain from trading was addressed by the U.S. Supreme Court in the landmark cases of Chiarella and Dirks. As discussed Chiarella expressly rejected the broader liability implications of the Cady, Roberts "access test" and Texas Gulf Sulphur's "possession test". The Supreme Court "refocused Section 10(b) insider trading rules on common-law fraud and fiduciary concepts".[1] The Court rejected the position that general notions of market fairness and equality of information were sufficient to create an affirmative duty to disclose. Rather the Court narrowed the basis of liability by stating that a duty to disclose arising from a relationship of trust and confidence between the parties had to exist in order for there to be actionable fraud under Rule 10b-5.

In Dirks the Supreme Court had another opportunity to address the scope of Rule 10b-5. This decision addressed the scope of a tippee's duty to disclose or refrain from trading on inside information. As discussed the Supreme Court held that a tippee acquires the disclosure duty when he obtains material, non-public information from an insider who breached a fiduciary duty to shareholders by tipping the information.

Dirks therefore confirmed the corporate fiduciary rationale of Chiarella.

> ". . . the Court confirmed its disavowel of the possession theory, and reaffirmed the fiduciary duty test as the foundation of the insider trading doctrine regardless of whether the information emanates from market sources outside the corporation or from internal corporate sources."[2]

There are some commentators who argue that this narrowing of the scope of insider trading liability in Dirks has struck a balance between the two competing goals of the 1934 Act, that is protection of the investing public and enhancement of market efficiency.[3] But it is this writer's view that the combined effect of Chiarella and Dirks has significantly limited the ability of the SEC and the courts to apply the insider trading doctrine to persons who are not corporate insiders and who do not otherwise owe a fiduciary duty to the corporation and its shareholders - in other words the non-traditional insiders. The SEC has sought to avoid the full impact of Dirks and Chiarella by relying on the newly fashioned theories of liability of misappropriation and constructive or temporary insiders. The development of these competing theories of liability are symptoms of the inconsistencies in the development of insider trading and the absence of an explicit, consistent rationale of liability. Following these cases, there is no general duty among all participants in market transactions to forego actions based on material, non-public information.[4]

As discussed in the case law, the SEC and lower courts have quickly embraced the misappropriation theory which arose out of Chief Justice Burger's dissent in Chiarella. The SEC has been successful in the use of this theory to apply Rule 10b-5 to insider trading not only by employees but also by tippees of an employee who had profited together with the employee from trading on the basis of misappropriated information. Commentators have argued that the misappropriation theory is inconsistent with the rationale of the Supreme Court decisions. The requirement of fraud in connection with the sale or purchase of securities is missing under the misappropriation theory because a general duty to disclose merely upon possession of illegally obtained information is imposed:

> "The misappropriation theory is an attempt to ensure a more equitable and fair market through absolute equality of information in the stock market. The Supreme Court, however has refused to allow the promotion of fairness through excessive restrictions on the workings of the market as illustrated in both Chiarella and Dirks."[5]

Thus the rationale of liability of the misappropriation theory of equal information conflicts with the corporate fiduciary basis of liability as set out in Chiarella and Dirks. The constructive or insider theory of liability is a theory enunciated by Dirks in footnote fourteen. However Dirks indicated only that the concept applied to professionals such as underwriters, accountants, lawyers and consultants who were working for the corporation. In a sense, these persons are temporarily employed by the corporation and thereby subject to many of the same duties as permanent employees. However as discussed it is doubtful that the Supreme Court intended the concept to be used as broadly as in the Lund case who had never occupied such a professional status.[6]

The insider trading case law that has developed after Dirks indicates the need for legislative reform. Such reform would resolve the present situation in which conflicting theories or rationales of liability, particularly as they relate to the non-traditional insider, are evolving unsystematically[7]. The result is uncertainty in the market place as to what behaviour will attract liability. This on-going debate in the United States over the most appropriate rationale for liability can provide those concerned with regulation of insider trading in Ontario with guidance and illustrations of the kind of problems one encounters with the extension of liability to non-traditional insiders.

(b) OUTSIDERS AND ONTARIO'S SECURITIES LEGISLATION

A review of the statutory scheme of the OSA and the resulting decisions primarily of the Ontario Securities Commission indicates that regulation of insider trading has proceeded with basic uniformity of purpose to achieve through Section 75 the continuous disclosure ethic sought under Section 74. The rationale for controlling insider trading in Ontario is the equality of information in the market place. As discussed, it is evident that Section 75 should be amended to equip the Commission with wider powers of proscription into trading that involves tippees. What is the appropriate rationale for the extension of such insider trading prohibitions?

It is submitted that the Dirks decision does provide valid criticism of the equal information theory in that this theory provides too broad a basis for insider trading liability in that liability arises from one's ability to acquire information because of one's position in the market place. The Supreme Court, it is submitted, correctly stressed the need to estalish guiding principles for those who operate in the market place. The efficiency demands of the capital market should be considered in any rationale of liability and too broad a basis for liability will lead to inefficiencies in the market place. Those trading in information will be uncertain as to what behaviour would be caught by insider trading rules and this uncertainty would result in delays in disclosing information, and a decrease in the pool of information.

It is this writer's view however that the Supreme Court went too far in narrowing the scope of liability in that the corporate fiduciary theory it espoused does not provide for the extension of liability to non-traditional insiders. A more appropriate and effective rationale for possible amendment proposals for Ontario's securities legislation is Brudney's access theory. As discussed, his theory is based on the inherent unfairness involved in a market where one party who possesses information that is not legally available to others is allowed to trade. Brudney's theory focuses on the unfairness created in the market place rather than on the abuse of position by a fiduciary. In Brudney's view insider trading prohibitions are designed primarily to protect the investing public from those who possess an informational advantage. The appeal of Brudney's theory lies in the guidance he provides as to where to draw the line as to who apart from insiders and those in a special confidential relationship should be subject to insider trading liability. Brudney's answer as to where the line is drawn is based on the inability of third parties to overcome lawfully the superior knowledge of those with whom they trade.[8] The securities market functions well with a minimum amount of uncertainty and maximum amount of information. Brudney's theory offers more certainty than the equal information theory and fewer restrictions with regard to non-traditional insiders than the corporate fiduciary theory. It is thus suggested that his theory may provide an excellent rationale for any amendment of the OSA that extends liability beyond traditional insiders.

As a legislative guide Ontario could well profit from its observation of the effects of Quebec's recent amendments to its Securities Act to extend liability to inter alia tippees.

Given the restrictions of the present legislation, it is likely that proposals for amendments providing for the widening of the liability net to include tippees and other outsiders will be forthcoming. The rationale provided for such an extension of liability may well reflect developments in this area in the United States.

CHAPTER VII

FOOTNOTES

1. R.A. Prentice "The Impact of Dirks On Outsider Trading" (1985) 13 Sec. Reg. L. J. 38 at 43.

2. R.M. Phillips and R.J. Zutz "The Insider Trading Doctrine: A Need For Legislative Repair" (1984) 13 Hofstra L. Rev. 65 at 67, 68.

3. E.A. Milton "The Supreme Court's Highwire Act: Balancing SEC Enforcement and Market Efficiency in Dirks v. SEC" (1984) 45 U. Pitt. L. Rev. 923 at 944.

4. S. Solinga "A Proposed New Regime of Insider Trading Regulation" (1986) 14 Sec. Reg. L. J. 99 at 104.

5. E. Duoma "The Misappropriation Theory: Too Much of a Good Thing?" (1985) 17 Pac. L. J. 111 at 128.

6. Phillips and Zutz, Supra, note 2 at 93.

7. Duoma, Supra, note 5 at 129.

8. S.M. Beck "Of Secretaries, Analysts and Printers: Some Reflections On Insider Trading" (1983-84) 8 Can. Bus. L. J. 385 at 395.

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