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Introduction

The late 1980's saw the convictions for insider trading of high-profile traders such as Ivan Boesky and Michael Milken. The courts also confronted allegations of insider trading by a variety of less well-known culprits, ranging from financial printers[1] to Wall Street Journal columnists.[2]

Recent decisions in the area reflect a recurring interaction between Congress, the federal courts and the Securities and Exchange Commission ("SEC") in the area of insider trading. Each legislative, judicial or regulatory action that attempted to define the parameters of lawful use of information has subsequently faced an expanding or narrowing rebuttal from another branch.

In October 1992, the Tenth Circuit decided in *SEC v. Peters*[3] that an insider trading defendant could be held liable under Rule 14e-3[4] without a breach of any fiduciary duty. This decision reflected the recently broadened scope of insider trading liability.

Section I of this Comment describes the major legislation, regulations and court decisions governing insider trading. Section II then discusses the *Peters* holding in light of these statutes, rules and judicial holdings. In Section III, the Comment examines the inappropriateness of a fiduciary duty requirement to liability for insider trading in tender offers and briefly discusses the future of insider trading liability under Rule 14e-3.

I. Background

SEC v. Peters[5] squarely confronted whether Rule 14e-3 required the existence of a fiduciary duty as a prerequisite to insider trading liability.

1. *See* Chiarella v. United States, 445 U.S. 222 (1980).
2. *See* Carpenter v. United States, 484 U.S. 19 (1987).
3. 978 F.2d 1162 (10th Cir. 1992).
4. 17 C.F.R. § 240.14e-3 (1993). Rule 14e-3 reads in pertinent part:

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

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

5. 978 F.2d 1162 (10th Cir. 1992).

The problem at the heart of insider trading is that such insiders commit fraud by their actions.

Those against promulgating insider trading regulations without a fiduciary duty requirement frame their argument in the following manner. The definition of fraud under Rule 14e-3 is identical to definitions under other insider trading sections that do not pertain to tender offers,[6] and court decisions have required a fiduciary duty in these contexts.[7] Therefore, a fiduciary duty requirement under 14e-3 is also appropriate.[8] Without such a requirement, the rule may ensnare innocent market traders engaged in legitimate market research, thereby discouraging the free exchange of information and creating a less efficient securities market. Since *Peters* was grounded in the notions of insider trading, fiduciary duty and tender offers, a survey of the historical progression of statutory, regulatory and case law on insider trading provides a helpful background. This history clearly reveals the continuous struggle over the appropriate definition of insider trading.

A. *The Law of Insider Trading Before 1980*

The Securities Exchange Act of 1934[9] provided the first federal legislation aimed at insider trading. This statute, among its other provisions, required insiders, including corporate directors, officers and ten percent owners of equity securities, to report their registered equity holdings and the monthly changes in those holdings to the SEC.[10] These requirements were followed by what has become known as section 10(b).[11] The SEC used this provision to promulgate the regulation that required traders to either disclose material inside information or abstain from trading on the basis of the information—Rule 10b-5.[12]

As discussed earlier, the breach of fiduciary duty requirement for insider trading liability rests on the policy notion that only those who are

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6. *See, e.g.*, 17 C.F.R. § 240.10b-5 (1993) [hereinafter Rule 10b-5] (the general anti-fraud provision for the purchase and sale of securities).

7. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980) (takeover bid context).

8. This view was framed in a similar manner in DONALD C. LANGEVOORT, INSIDER TRADING REGULATION § 7.05, at 217 (1991 ed.).

9. Pub. L. No. 73-291, 48 Stat. 905 (codified as amended at 15 U.S.C. § 78 (1988 & Supp. IV 1992)).

10. Securities Exchange Act § 16, 15 U.S.C. § 78p(a) (1988); *see also* Iman Anabtawi, Note, *Toward a Definition of Insider Trading*, 41 STAN. L. REV. 377, 380 (1989) (discussing these requirements).

11. Securities Exchange Act § 10, 15 U.S.C. § 78j (1988). Section 10 reads in pertinent part:

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

12. 17 C.F.R. § 240.10b-5 (1993). For a brief discussion of the "disclose or abstain" impact of Rule 10b-5, see Anabtawi, *supra* note 10, at 381.

truly culpable should be penalized.[13] If a relationship of trust and confidence between the accused insider and another party has been breached, it is more likely that the insider has used the information to trade for personal gain.

Early decisions applying Rule 10b-5 contained a fiduciary duty requirement for insider trading liability. *In re Cady, Roberts & Co.*,[14] a 1961 SEC decision, involved a partner in a broker-dealer firm who used advance knowledge of a dividend reduction in another company in which the partner was also a director to sell shares before the price dropped on the New York Stock Exchange.[15] In finding the partner liable, the SEC stated that "corporate 'insiders,' particularly officers, directors or controlling stockholders," have a duty to disclose material information before trading on the basis of that information,[16] a duty based on the fiduciary relationship between corporate officers and shareholders.[17]

The Second Circuit, in *SEC v. Texas Gulf Sulphur Co.*,[18] noted that Rule 10b-5 aimed to provide all securities market participants equal access to material information.[19] The court stated that corporate insiders such as directors or officers fell within the rule's ambit. Again, such individuals have a fiduciary duty to their shareholders not to "take 'advantage of such information knowing it is unavailable to those with whom [they are] dealing.' "[20]

In 1968, Congress recognized the need for stricter insider trading regulation and passed the Williams Act,[21] which, among other things, amended the 1934 Act by lowering the disclosure threshold for equity shareholders from ten percent to five percent.[22] Section 14(e),[23] a provision of the Williams Act, was designed to regulate insider trading related to tender offers. More specifically, the statute granted the SEC authority

13. *See* Dirks v. SEC, 463 U.S. 646, 662 (1983) (holding that liability under Rule 10b-5 depended on whether the insider "personally . . . benefit[ted], directly or indirectly, from his disclosure").

14. 40 S.E.C. 907 (1961).

15. *Id.* at 910-11.

16. *Id.* at 911.

17. *See id.*

18. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

19. *Id.* at 848.

20. *Id.* (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)).

21. Pub. L. No. 90-439, 82 Stat. 454 (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988)).

22. 15 U.S.C. § 78n(d)(1) (1988). This provision should be distinguished from the ten percent *registration* requirement in 15 U.S.C. § 78(p)(a) (1988). *See also* Nathaniel B. Smith, Note, *Defining "Tender Offer" Under the Williams Act*, 53 BROOK. L. REV. 189, 191 (1987) (discussing congressional intent to mandate disclosure in passing the Williams Act).

23. Pub. L. No. 90-439 § 3(e), 82 Stat. 455 (codified at 15 U.S.C. § 78n(e) (1988)). Section 14(e) reads in pertinent part:

> It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

to regulate tender offers by "defin[ing], and prescrib[ing] means reasonably designed to prevent, such acts as are fraudulent, deceptive, or manipulative."[24] This broad grant of authority seemed to portend stricter regulation of the financial markets. The Supreme Court took the next major step in this area; however, it was a step backward.

B. Chiarella v. United States[25] *and its Progeny: Insider Trading Law Since 1980*

The Supreme Court discussed the fiduciary duty requirement in *Chiarella*,[26] a case which defined the insider trading liability debate for all subsequent federal court decisions in the area. *Chiarella* involved an alleged violation of Rule 10b-5. The defendant worked for a financial printer contracted to print takeover documents. The defendant used information from the documents to purchase shares in the target company and then sold the shares for a profit after the bids became public.[27]

The Supreme Court found the defendant not liable under Rule 10b-5 because he owed no fiduciary duty to the target company's shareholders and therefore had no duty to disclose the information.[28] The Court borrowed this fiduciary duty requirement from the notion of fraudulent nondisclosure in the Restatement (Second) of Torts.[29] Although the Court framed insider trading as fraudulent nondisclosure that deprived shareholders of the increased profits to be made after public announcement of takeover bids, it stated that without a fiduciary duty, there can be no fraud.[30]

A dissent by Chief Justice Burger, however, foreshadowed later federal court decisions, including *Peters* (albeit in a Rule 10b-5 context). The Chief Justice supported the concept of an absolute duty to disclose or abstain based on a defendant's misappropriation of information, without any breach of a specific fiduciary duty.[31]

Whether jumping through the window left open by Burger or simply responding to the narrow majority definition of impermissible insider trading in *Chiarella*, the SEC quickly fired back. Using the authority granted by § 14(e), it promulgated Rule 14e-3[32] in 1980. This rule prohibited securities trading on the basis of an impending, unannounced tender offer if knowledge of the offer comes from the offeror, the issuer of securities or an officer, director, partner or employee of the offering party or

24. *Id.*
25. 445 U.S. 222 (1980).
26. *Id.* at 227-28.
27. *Id.*
28. *Id.* at 232.
29. *See id.* at 228 & n.9 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).
30. *Chiarella*, 445 U.S. at 235.
31. *Id.* at 240 (Burger, C.J., dissenting).
32. 17 C.F.R. § 240.14e-3 (1993).

the issuer.[33] Most significantly, Rule 14e-3 did not require a breach of fiduciary duty as a prerequisite to liability.

The tender offer has presented a new challenge to the definition of insider trading liability. The challenge lies not only in the number of participants, any one of whom may potentially have access to information about the tender offer before it is publicly announced, but also in the potential harm to the vast number of shareholders of the target company. Although § 14(e) does not contain a definition of the tender offer, several federal courts, in construing the statute, have identified factors for determining the presence of a tender offer.[34]

Several other definitions of a tender offer have been forwarded, most of which contain overlapping elements.[35] Tender offers are usually made for a large percentage of the corporation's stock, for a price above the shares' market price, and are often open for a limited time.[36]

In this type of securities transaction, the range of individuals with access to inside information could include investment analysts,[37] financial printers contracted to print tender offers,[38] financial journalists[39] and others who have contact with either the acquiring company or the selling (target) company. In such a context, it is difficult to pinpoint information sources, and, as a result, the SEC adopted the broadly worded Rule 14e-3.

33. 17 C.F.R. § 240.14e-3(a) (1993). For a discussion of Rule 14e-3's restrictions, see Anabtawi, *supra* note 10, at 382.

34. The Fifth Circuit looks to eight factors in determining whether a stock purchase is a tender offer: (1) active and widespread solicitation of shareholders for an issuer's shares; (2) solicitation is made for a substantial percentage of the issuer's stock; (3) offer to purchase at a premium over the prevailing market price; (4) terms of the offer are not negotiated; (5) offer is contingent on the tender of a fixed minimum number of shares, and perhaps, subject to a maximum number to be purchased; (6) offer is open for a limited time; (7) offerees are subject to pressure to sell; and (8) public announcements of a purchasing program concerning the target company precede or accompany a rapid accumulation of large amounts of target company securities. Pin v. Texaco, Inc., 793 F.2d 1448, 1454 (5th Cir. 1986). Other decisions incorporating this set of factors include SEC v. Carter Hawley Hale Stores, Inc., 760 F.2d 945, 949-952 (9th Cir. 1985); Energy Ventures, Inc. v. Appalachian Co., 587 F. Supp. 734, 740 (D. Del. 1984); Wellman v. Dickinson, 475 F. Supp. 783, 823-26 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

The Second Circuit has used a two-part test to identify tender offers in § 14(d)'s tender offer disclosure context: (1) "a substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal put before them;" (2) "whether the particular class of persons needs the protection of the [Securities] Act." Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 57 (2d Cir. 1985) (citation omitted).

The Fifth Circuit has incorporated both the preceding tests in determining whether a tender offer has been made, albeit in a § 14(e) discussion. *See* Anago Inc. v. Tecnol Medical Products, Inc., 792 F. Supp. 514, 516-517 (N.D. Tex. 1992), *aff'd*, 976 F.2d 248 (5th Cir. 1992), *cert. denied*, 114 S. Ct. 491 (1993).

35. *See, e.g.*, Proposed Amendments to Tender Offer Rules, SEC Release Nos. 33-6159, 34-16385, 44 Fed. Reg. 70,349, 70,350-51 (1979) (codified as amended without the proposed definition at 17 C.F.R. § 240.14d-1(b) (1993)). For a discussion of this proposal and others, see Steve Mather, *The Elusive Definition of a Tender Offer*, 7 J. CORP. L. 503, 513 (1982).

36. *See* Wellman v. Dickinson, 475 F. Supp. 783, 823-26 (S.D.N.Y. 1979) (looking to factors listed *supra* note 34), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

37. Dirks v. SEC, 463 U.S. 646 (1983).

38. Chiarella v. United States, 445 U.S. 222 (1980).

39. Carpenter v. United States, 484 U.S. 19 (1987).

Two years later, however, the Court expanded on its *Chiarella* analysis in *Dirks v. SEC.*[40] *Dirks* involved an investment analyst who heard from a former corporate officer that the company's assets were fraudulently overstated. The analyst, wanting to expose the fraud, did his own investigation by interviewing several company officers and employees. Some of the interviews corroborated the fraud allegation. Dirks discussed his findings with several clients, who then sold their equity funding shares in the company.[41]

The Court held Dirks breached no fiduciary duty to the corporate shareholders.[42] The Court began its analysis by reemphasizing its *Chiarella* holding that it is not illegal to trade on inside information when no fiduciary relationship exists.[43] The Court characterized Dirks as a tippee, because he received his information from company insiders, and asserted "a tippee assumes a fiduciary duty . . . when the [tipping] insider has breached his fiduciary duty . . . and the tippee knows or should know that there has been a breach."[44] It then found that, since Dirks' sources had breached no duty,[45] Dirks could not be guilty of a "derivative breach."[46]

The federal courts of appeals largely followed the Supreme Court's lead when confronted with opportunities to define insider trading liability. Situated in the nation's financial center, the Second Circuit spoke first in *United States v. Newman.*[47]

The defendant in *Newman*, a securities trader, received secret information from investment bankers about proposed acquisitions and mergers and then passed this information on to individuals who traded and profited.[48] The Second Circuit, using the duty requirement from *Chiarella*, held that the defendant violated Rule 10b-5 by aiding the tipping investment bankers in violating the fiduciary duty owed to their employers,[49] since those companies relied on their reputation as safe havens for their customers' confidence.[50]

Three years later, the Second Circuit held a defendant's insider trading to be a breach of duty in *SEC v. Materia*,[51] this time describing a financial printer's procurement of nonpublic information about a pending tender offer as a fraud against his employer's reputation.[52] The Third Circuit adopted the fiduciary duty requirement in *Rothberg v. Rosenbloom.*[53]

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40. 463 U.S. 646 (1983).
41. *Id.* at 648-49.
42. *Id.* at 667.
43. *Id.* at 654-55.
44. *Id.* at 660.
45. The court of appeals noted that the tippers derived no monetary gain from the information given Dirks and had no intent to divulge profitable information. To the contrary, "the tippers were motivated by a desire to expose fraud." *Id.* at 667.
46. *Id.*
47. 664 F.2d 12 (2d Cir. 1981).
48. *Id.* at 15.
49. *Id.* at 15-16.
50. *Id.* at 17.
51. 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).
52. *Id.* at 199, 202.
53. 771 F.2d 818 (3d Cir. 1985).

According to the court, any insider to a proposed transaction is liable for insider trading if he or she breaches the fiduciary duty owed to his or her corporation.[54]

Many of the federal district court insider trading decisions during this era came from the Southern District of New York, whose jurisdiction encompasses Wall Street. This court held in *O'Connor & Associates v. Dean Witter Reynolds, Inc.*[55] that persons other than corporate shareholders have a duty to abstain or disclose if they acquire material nonpublic information.[56] This statement approximated a holding that the existence or absence of fiduciary duty is irrelevant to insider trader liability. Three years later, however, the same court relied on a breach of fiduciary duty to the target (selling) company in a takeover bid in *SEC v. Musella.*[57] The court later expanded the scope of liability slightly in *SEC v. Tome*[58] by holding the duty may be owed to anyone, not just the target company.[59] Nevertheless, the duty requirement remained.

With the *Chiarella* decision, the subsequent holding in *Dirks* and the consistent lower federal court decisions, the judiciary had drawn the most permissive parameters yet for insider trading. Fear of slanting the securities market playing field in favor of financial insiders created a situation ripe for a strengthening the law. Much later, the Supreme Court itself may have reacted to such a climate in *Carpenter v. United States*[60] when it viewed a *Wall Street Journal* columnist's insider trading activity as a breach of fiduciary duty to the newspaper itself.[61] Defendant Winans had given out advance information regarding the content of his column in return for a share of the profits made by trading on the information.[62] A divided Court upheld the defendants' convictions.[63]

The Court's decision, however, came seven years after *Chiarella* and hardly heralded a wholesale shift in insider trading restrictions. Additionally, its decision in *Dirks* did not invalidate Rule 14e-3. The Court's silence left the burden of clarifying the boundaries of insider trading liability under Rule 14e-3 to the Second Circuit's decision in *United States v. Chestman.*[64]

In 1990, a panel of the Second Circuit reversed Robert Chestman's conviction for insider trading in connection with a tender offer.[65] In so

54. *Id.* at 822.

55. 529 F. Supp. 1179 (S.D.N.Y. 1981).

56. *Id.* at 1186. *O'Connor* also dealt with Rule 14e-3 liability, noting that the rule only requires " 'substantial . . . steps to commence' " a tender offer to bring an insider trader within the scope of the rule. *Id.* at 1189 (quoting 17 C.F.R. § 240.14e.3 (1993)).

57. 578 F. Supp. 425, 436 (S.D.N.Y. 1984).

58. 638 F. Supp. 596 (S.D.N.Y. 1986).

59. *Id.* at 618.

60. 484 U.S. 19 (1987) (evenly divided decision).

61. *Id.* at 27-28.

62. *Id.* at 25.

63. *Id.* at 28.

64. 947 F.2d 551 (2d Cir. 1991) (en banc) [hereinafter Chestman II], *cert. denied*, 112 S. Ct. 1759 (1992).

65. United States v. Chestman, 903 F.2d 75, 84 (2d Cir. 1990) [hereinafter Chestman I], *vacated on reh'g en banc*, 947 F.2d 551 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 1759 (1992).

doing, the panel divided on the issue of the validity of Rule 14e-3. Although Judge Miner, writing for the court, specifically noted the SEC was acting within its § 14(e) authority in promulgating the rule,[66] two judges disagreed. Judges Mahoney[67] and Carman[68] concluded that the agency had exceeded its statutory powers in adopting the rule.

Upon rehearing *en banc*, the Second Circuit reaffirmed Rule 14e-3 as a valid exercise of the SEC's legislative mandate.[69] In the process, the court quoted the Supreme Court in *Schreiber v. Burlington Northern, Inc.*[70] for the proposition that the SEC had the authority to promulgate prophylactic rules under § 14(e).[71] The Second Circuit explicitly stated that no fiduciary duty is necessary to create liability for one who trades on material nonpublic information.[72]

With the need in *Chestman* for an *en banc* reconsideration of Rule 14e-3's validity and the absence of any pronouncements from the Supreme Court, the scope of tender offer-related insider trading liability was far from resolved. The next opportunity to consider the issue fell to the Tenth Circuit.

II. *SEC v. Peters*[73]

In a partnership setting, partners have a duty to each other, limited to the scope of the partnership's business, not to gain advantage through false statements, failures to disclose, threats or pressure.[74] A partner's failure to disclose knowledge of information regarding an impending tender offer was at the center of the Tenth Circuit's discussion of fiduciary duty, and its validation of Rule 14e-3,[75] in *Peters*.[76]

A. *Facts*

Don Peters and Ivan West were partners in Investment Management Group ("IMG"). West did consulting work outside the partnership for Energy Resources Group, Inc. ("ERG"). This work included seeking a friendly acquirer for ERG.[77] West found a purchaser. Shortly before the announcement of the tender offer, Peters allegedly tipped information about the purchase to individuals who purchased shares of ERG stock.[78]

66. *Id.* at 83-84.
67. *Id.* at 84 (Mahoney, J., concurring in part and dissenting in part).
68. *Id.* at 86 (Carman, J., concurring in part and dissenting in part).
69. Chestman II, 947 F.2d at 559-60.
70. 472 U.S. 1 (1985).
71. Chestman II, 947 F.2d at 563 (quoting *Schreiber*, 472 U.S. at 11 n.11).
72. *Id.* at 557 (asserting that Rule 14e-3 "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information").
73. 978 F.2d 1162 (10th Cir. 1992).
74. 59A Am. Jur. 2d *Partnership* § 420 (1987) (outlining duties among partners); *see* Peters, 978 F.2d at 1168 (discussing some of these principles).
75. 17 C.F.R. § 240.14e.3 (1993).
76. 978 F.2d at 1164, 1167-68.
77. *Id.* at 1164.
78. *Id.*

After public announcement, these individuals sold their shares at a profit of $2.00 to $2.50 per share.[79] Peters allegedly gained access to the information from memos in a notebook West left on his desk at the IMG office.[80]

The SEC filed a civil suit against Peters, alleging violations of § 10(b)[81] of the Securities Exchange Act of 1934 as well as SEC Rules 10b-5[82] and 14e-3.[83] At trial, the jury found Peters not liable for any violations. The Tenth Circuit reversed and remanded, finding the district court erred in instructing the jury that a Rule 14e-3 violation required breach of a fiduciary duty.[84]

B. *The Court's Analysis*

In holding that Peters could be held liable without any fiduciary duty to West, the court of appeals found that Rule 14e-3 required no implied fiduciary duty[85] and was a valid promulgation under congressional authority granted through § 14(e).[86] The court explained that the district court's erroneous jury instruction was not harmless error, since the jury might have found for Peters because West's ERG work was outside the partnership's business and therefore beyond the reach of Peters' fiduciary relationship with West.[87]

The court concluded that § 14(e) granted the SEC liberal rulemaking authority to promulgate a rule as broad as 14e-3. The court adopted two policy arguments to support its holding. First, since Rule 14e-3 was aimed specifically at deterring insider trading in the tender offer context, it is not subject to the same fiduciary duty requirement as Rule 10b-5.[88] To hold otherwise, the court suggested, would "do nothing more than . . . proscribe conduct already proscribed by Section 10(b) and Rule 10b-5."[89] Second, the court ruled that in a tender offer context, where many players are involved who may have no loyalty to the target company, a fiduciary duty requirement posed an evidentiary hurdle incompatible with the spirit of the authority granted to the SEC in § 14(e).[90]

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79. *See* Appellant's Brief at 8, SEC v. Peters, 978 F.2d 1162 (10th Cir. 1992) (No. 90-3346).

80. *See* SEC v. Peters, 735 F. Supp. 1505, 1512-14 (D. Kan. 1990), *rev'd*, 978 F.2d 1162 (10th Cir. 1992).

81. 15 U.S.C. § 78j (1988).

82. 17 C.F.R. § 240.10b-5 (1993).

83. *Peters*, 978 F.2d at 1164.

84. *Id.* at 1165-68. The court found a second ground for reversal in an evidentiary issue that will not be discussed in this Comment. *See id.* at 1168-73; *see also id.* at 1173-77 (Alley, J., concurring in part and dissenting in part) (agreeing with the majority on the Rule 14e issue).

85. *Id.* at 1167.

86. *Id.*; *see* 15 U.S.C. § 78(n)(e) (1988).

87. *Id.* at 1167-68.

88. *Id.* at 1166 n.4. (citing Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 10-11 (1985) (stating that § 14(e) is addressed specifically to disclosure in the tender offer context)).

89. *Id.*

90. *See id.* at 1167; *see also* H.R. REP. No. 910, 100th Cong., 2d Sess. 15 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6052 (making the connection between the investor and inside information can be an obstacle to prosecuting insider trading cases).

The court of appeals buttressed these policy arguments with reference to the passage of the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"),[91] which the court saw as a ratification of Rule 14e-3.[92] Although the ITSFEA hearings or reports made no reference to Rule 14e-3, the court presumed Congress was aware of the existence of a rule on such a closely related issue.[93] Congress designed the 1988 Act to strengthen the enforcement of existing insider trading laws,[94] and not to abridge the SEC's powers under § 14(e) and Rule 14e-3 to regulate insider trading.

The Tenth Circuit framed its decision as a natural extension of emerging insider trading law. It appealed to prior statutory mandate and legislative history and noted the SEC's need for adequate measures to police the securities marketplace by holding that insider trading liability in the tender offer context does not require a breach of fiduciary duty. The court cited *Chestman,* which directly stated this proposition.[95] *Peters* confirmed the en banc *Chestman* validation of Rule 14e-3 and continued the Second Circuit's broad proscription of insider trading activity.

III. Analysis

Congress, the courts, and the SEC have struggled to properly define insider trading liability parameters. As the Williams Act,[96] *Chiarella v. United States,*[97] Rule 14e-3,[98] *Dirks v. SEC,*[99] *United States v. Chestman*[100] and *SEC v. Peters*[101] illustrate, these definitions have often taken the form of sharp reactions to another entity's pronouncements on the subject.

Recent court decisions, however, indicate the parameters may finally be stabilizing. The Tenth Circuit's refusal in *Peters* to read a fiduciary duty requirement into Rule 14e-3 is consistent with *Chestman;* moreover, the decision will enhance the integrity of securities markets without inhibiting legitimate market research and communication.

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91. Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended at 15 U.S.C. § 78u-1 (1988 & Supp. IV 1992)).

92. *Peters,* 978 F.2d at 1167.

93. *Id.*

94. *See* H.R. Rep. No. 910, 100th Cong., 2d Sess. 35 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6072; *see also* Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988,* 68 N.C. L. Rev. 465, 475 (1990) (citing legislative history of the 1988 Act as validation of Rule 14e-3).

95. *See* United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (en banc), *cert. denied,* 112 S. Ct. 1759 (1992).

96. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1988).

97. 445 U.S. 222 (1980).

98. 17 C.F.R. § 240.14e-3 (1993).

99. 463 U.S. 646 (1983).

100. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied,* 112 S. Ct. 1759 (1992).

101. 978 F.2d 1162 (10th Cir. 1992).

A. *Different Contexts, Different Bases for Insider Trading Liability: Rules 10b-5*[102] *and 14e-3*

1. Section 14(e)[103]

Section 14(e) grants the SEC power to take steps "reasonably designed"[104] to prevent unlawful activities in the tender offer context, and it contains no evident fiduciary duty requirement. Some writers have questioned whether Rule 14e-3 is simply a retread of Rule 10b-5 aimed at preventing fraud. These critics of the *Chestman/Peters* approach point to the similarity in language between Rule 10b-5 and Rule 14e-3 and reason that Rule 14e-3 should be subject to the same duty requirement as has been read into Rule 10b-5.[105]

This criticism ignores the difference between § 10(b) and § 14(e) and the problems they address. The SEC aimed Rule 14e-3 directly at tender offers.[106] The unique trading context of the tender offer creates a need for different regulatory techniques. In its release accompanying the promulgation of Rule 14e-3, the SEC clearly stated that Rule 14e-3 addresses a different concern than Rule 10b-5—tender offers.[107]

2. Legislative History of Insider Trading Statutes

The legislative history behind § 14(e) and ITSFEA[108] also supports the Tenth Circuit's holding in *Peters*. The SEC provided the Senate Subcommittee on Securities with a memorandum during the consideration of § 14(e).[109] The memorandum specifically referred to the problem of individuals trading on undisclosed information regarding an upcoming tender offer—the exact scenario played out in *Peters*. Significantly, the memo contained no mention of a fiduciary requirement in its discussion of liability for insider trading in tender offer contexts.[110]

It is not surprising that the SEC interpreted the legislation in an expansive manner. Statements by representatives of the financial community before the Senate Subcommittee indicated the group most affected by this new legislation also agreed on the need for broad SEC regulatory pow-

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102. 17 C.F.R. § 240.10b-5 (1993).

103. 15 U.S.C. § 78n(e) (1988).

104. *Id.*

105. *Report of the ABA Task Force on Regulation of Insider Trading, Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934, reprinted in* 41 BUS. LAW. 223, 251 (1985).

106. *See* 17 C.F.R. § 240.14e-3(a) (1993).

107. SEC Release Nos. 33-6239; 34-17120, 45 Fed. Reg. 60410, 60412 n.20 (1980); *see also* Karen A. Tallman, Note, *Private Causes of Action under SEC Rule 14e-3*, 51 GEO. WASH. L. REV. 290, 296 (1983) (discussing congressional concern with equal access to material information concerning tender offers).

108. 15 U.S.C. § 78u-1 (1988 & Supp. IV 1992).

109. *See Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen, Hearing on S. 336 and S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 12 (1970) (SEC memorandum submitted to Senate Subcommittee on Securities).

110. *See id.* For a brief discussion of the SEC memorandum, see Friedman, *supra* note 94, at 474.

ers in the tender offer context.[111] Congress was thus well aware of the notion of broad authority for the SEC under § 14(e), and the finished product, as discussed above, indicates no disagreement with such an interpretation—one which presages the *Peters* decision.

Legislative history of ITSFEA also supports the interpretation that § 14(e) does not require a fiduciary duty. Congress designed ITSFEA to strengthen existing enforcement of securities trading.[112] Committee reports indicate Congress was fully aware of the evidentiary hurdles that hindered the pinpointing of inside information in tender offers.[113]

Whatever the motive for the original omission, Congress had a clear opportunity to enact a duty requirement in 1988 if it so desired. During ITSFEA hearings, the Senate Securities Subcommittee was directly asked to consider the adequacy of the SEC's regulatory remedies,[114] and the parallel House Subcommittee was given a thorough explanation of the misappropriation theory, which contains no fiduciary duty requirement.[115] With a direct opportunity to reconsider restrictions on insider trading liability, Congress declined to add a fiduciary duty prerequisite to liability in the tender offer arena.

B. *The Tenth Circuit's Interpretation of Rule 14e-3: Promoting Fairness Without Discouraging the Lawful Flow of Information*

A broad scope of liability, including the absence of the fiduciary duty prerequisite, should enhance the integrity of the securities market. At the same time, it should not adversely affect the legitimate communication of information in the markets.

The need for broader regulatory authority vis-a-vis tender offers is apparent. Tender offers involve any number of shareholders who are rightfully entitled to the profits generated by selling shares after public announcement of the offer. Any individual who gains access to information about the impending offer, regardless of whether any fiduciary duty is owed to anyone, can trade (factually, not legally) on that information before public announcement. If a person does, the person defrauds the

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111. *See, e.g., Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exemptions for Small Businessmen: Hearing on S. 336 and S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 116 (1970) (statement of Craig Severance, Chairman of the Federal Securities Acts Committee, Investment Bankers Association).

112. *See supra* note 94 and accompanying text.

113. *See, e.g.*, H.R. REP. No. 910, 100th Cong., 2d Sess. 15 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6052.

114. "The third and final question I have asked our witnesses to address is this. Does the SEC currently have adequate resources to do its job correctly and *does it possess adequate remedies to deter securities laws violations?*" *Oversight of the Securities and Exchange Commission and the Securities Industry: Hearing on the Proper Roles of Government and Self-Regulation in Light of the Shift in Policy Focus of the SEC in the Past Few Years Before the Subcomm. on Securities of the Senate Committee on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 2 (1987) (statement of Sen. Donald W. Riegle, Jr., Chairman of the Subcomm. on Securities) (emphasis added).

115. *SEC and Insider Trading: Hearing Before the Subcomm. on Oversight and Investigations of the House Committee on Energy and Commerce*, 99th Cong., 2d Sess. 80-81 (1986) (statement of John Shad, Chairman of the SEC).

shareholders "as surely as if that person took their money."[116] In fact, such traders are taking money in the form of potential profits. The passage of § 14(e) reflected the need to eliminate such fraud, irrespective of any fiduciary relationship.[117]

The language in § 14(e), the legislative history of recent insider trading statutes, and the trend away from a fiduciary duty requirement in recent tender offer cases all support an absence of the fiduciary duty requirement under Rule 14e-3. These arguments are buttressed by reviewing who the fiduciaries generally are—corporate insiders. It is fraudulent for those insiders to trade on the basis of nonpublic material information without disclosure in the corporate context, because those insiders owe a fiduciary duty of disclosure to their shareholders when engaged in purchases from or sales to those shareholders.[118]

The "insider" relationship which gives rise to the fiduciary duty in the Rule 10b-5 context[119] may not be present in tender offers. The tender offeror is not a director or officer of the target company, and therefore, the offeror has no fiduciary duty to the shareholders of the target company. Limiting liability to those with a fiduciary duty to the target company's shareholders would insulate from liability all those who are privy to the information because of a relationship with the tender offeror.

The plans of the tender offeror are cloaked in secrecy from the target shareholders. Just as the Williams Act aimed to protect target shareholders through disclosure requirements,[120] the SEC must be able to protect those shareholders by broadly regulating the insider trading that potentially can be effected by anyone with nonpublic knowledge about a future tender offer.

This regulatory mandate should not have the effect of trampling the flow of information, including lawful market research and communication about transactions. The key to preserving legitimate dissemination of information is found in Rule 14e-3 itself. The Rule establishes liability only for those who know, or should know, that the information about the impending tender offer is not yet public and that the information came from any one of a list of 'insiders' to the upcoming tender offer.[121] Therefore, an insider or his tippee is subject to liability. The innocent individual who gleans information which he or she does not know, and has no reason to

116. United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981).

117. *See* H.R. REP. No. 1711, 90th Cong., 2d Sess. 11 (1968), *reprinted in* 1968 U.S.C.C.A.N. 2811, 2821 (emphasizing need to prevent fraudulent or manipulative practices and making no mention of fiduciary duty requirement).

118. *See, e.g.*, Kohler v. Kohler Co., 319 F.2d 634, 637-38 (7th Cir. 1963); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa.), *opinion supplemented by* 83 F. Supp. 613 (E.D. Pa. 1947). For a historic overview of the corporate insider as fiduciary, see LANGEVOORT, *supra* note 8, § 2.02, at 35-39.

119. Tippees have a duty to abstain or disclose as well as corporate insiders under Rule 10b-5. HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK § 19.01[4] (1993 ed.). The tippee's fiduciary duty, however, stems from the fact an insider with a fiduciary duty has disclosed the information to the tippee. *Id.* § 19.01, at 19-10 (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

120. *See supra* note 117, at 2811-13.

121. 17 C.F.R. § 240.14e-3(a) (1993).

know, is nonpublic, even though it is in fact nonpublic, and who did not know the information came from someone on the Rule's "list," may still trade on that information without liability. The duty to abstain or disclose, however, is still intact under Rule 14e-3, as interpreted by *Peters*, for those persons who have "reason to know" that the information is not yet public or that the information has its source in one of the listed individuals in Rule 14e-3.[122]

The regulation also mandates that a "substantial step or steps to commence" a tender offer be taken before the abstain or disclose rule takes effect.[123] Therefore, market analysts making or recommending investment decisions on the basis of pure research, in the absence of any activity having been taken regarding the tender offer, are not subject to liability.

The Rule further limits liability by requiring that the nonpublic information traded on must be "material."[124] The SEC notes that information about intentions to make a tender offer, as well as information about the withdrawal of tender offers or increases in consideration being offered to target company shareholders, would be material.[125]

The "anti-tipping" provision in Rule 14e-3(d)[126] also allows for some flexibility.[127] The provision provides for liability only where it was "reasonably foreseeable" to the tipper that the tip could result in a Rule 14e-3 violation.[128] This language acts as a safeguard to the innocuous communication of market information to one, for example, who is not an investor or associated with investors.

Finally, the Rule provides for two exceptions to the abstain or disclose requirement. Brokers or agents for the tender offeror may purchase securities for the tender offeror.[129] Additionally, target company shareholders who have received material nonpublic information from the tender offeror may sell stock to the offeror.[130]

Rule 14e-3 thus has its intended effect: to enforce prohibitions of insider trading regarding tender offers without the irrelevant hindrance of a fiduciary duty prerequisite, while allowing legitimate, untainted market communication surrounding market transactions to take place.

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122. *Id.*

123. *Id.* Such steps could include: voting by the offeror's board of directors on a resolution to make an offer; devising a plan to make such an offer; arrangement of financing for the offer; preparing tender offer materials; and authorizing negotiations in connection with a tender offer. SEC Release Nos. 33-6239; 34-17120, *supra* note 107, at 60,413 n.33.

124. 17 C.F.R. § 240.14e-3(a) (1993).

125. SEC Release Nos. 33-6239; 34-17120, *supra* note 107, at 60,413 n.35.

126. 17 C.F.R. § 240.14e-3(d) (1993).

127. *See* LANGEVOORT, *supra* note 8, § 7.04 (discussing reach of Rule 14e-3(d) liability).

128. 17 C.F.R. § 240.14e-3(d)(1) (1993).

129. *Id.* § 240.14e-3(c).

130. *Id.* § 240.14e-3(c)(2). The SEC's rationale for this exception is that the potential for abuse of the information in such a scenario is "negligible." SEC Release Nos. 33-6239; 34-17120, *supra* note 107, at 60,416.

C. *Insider Trading Law After* Peters

1. Back to the Future: The Decline of the Fiduciary Duty Requirement

As noted, the *Peters* decision follows *Chestman* in refusing to read a fiduciary duty requirement into Rule 14e-3. The Supreme Court has yet to speak on Rule 14e-3 in the wake of *Chestman* and *Peters.* In *Chiarella* and other earlier lower-level federal decisions, however, one can find clues suggesting future federal decisions will omit the fiduciary duty requirement altogether.

The Supreme Court's 1980 *Chiarella* decision specifically laid out the fiduciary duty prerequisite to insider trading liability. Within that decision, however, lay a clue to the Court's underlying theory of liability. The duty to abstain or disclose, according to the Court, arose not just from a fiduciary relationship but also from "the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."[131] The reference to "unfairness" reveals a concern for protecting honest traders that has at least as much to do with notions of a level playing field of information as it does with fiduciary relationships.[132]

The "fairness" basis for liability, although far from fruition at the Supreme Court level, has been more clearly evidenced in the federal courts of appeals. By the time of its decision in *SEC v. Materia,*[133] the Second Circuit was straining to fit notions of duty into a tender offer scenario. The Second Circuit then completely ended its reliance on a fiduciary duty requirement for Rule 14e-3 in *United States v. Chestman.*[134] Seen in this context, *Peters* looks a lot less like trail blazing and more like continuing an existing trend toward upholding the broad regulatory authority Congress intended to give the SEC.

2. Judicial Interpretation of "Reasonably Designed to Prevent"

The *Chestman* and *Peters* decisions may also reflect an increased willingness of federal courts to broadly interpret the "reasonably designed to prevent" language[135] that appears in several other SEC rules.[136] The Sec-

131. Chiarella v. United States, 445 U.S. 222, 227 (1980) (citing *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 & n.15 (1961)).

132. For further discussion on the trend away from fiduciary duty and toward "unfairness" as a basis for insider trading liability, even in the Rule 10b-5 context, see LANGEVOORT, *supra* note 8, § 2.02[3], at 44-45 (noting the fiduciary duty concept makes little sense in light of the fact the insider trading law now provides liability for tippees as well as corporate insiders).

133. 745 F.2d 197 (2d Cir. 1984), *cert. denied,* 471 U.S. 1053 (1985).

134. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied,* 112 S. Ct. 1759 (1992).

135. 17 C.F.R. § 240.14e-3(d)(1) (1993) reads:

> As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section *except* that this paragraph shall not apply to a communication made in good faith.

ond Circuit held that the delegation of authority to the SEC to make rules "reasonably designed to prevent" fraudulent trading activity includes the power to regulate conduct other than fraud.[137] Likewise, the Tenth Circuit stated that such rulemaking authority allows the SEC to "ease the evidentiary burden" inherent in tender offer insider trading by eliminating the fiduciary duty requirement.[138]

What remains to be seen is whether these broad interpretations of the "reasonably designed to prevent" language will work their way into cases involving aspects of securities fraud beyond insider trading, such as the regulation of both tender offeror practices[139] and target company practices.[140] The Tenth Circuit's broad interpretation of this language may have an effect beyond insider trading.

CONCLUSION

Congress, the courts, and the SEC have engaged in a series of insider trading liability definitions since the Securities Exchange Act of 1934.[141] Their definitions have often represented negative reactions to another branch's definition, so that in recent years the parameters of insider trading liability have been in flux, particularly with respect to tender offers.

The Tenth Circuit's holding in *SEC v. Peters*[142] discloses a broad-based theory of insider trading liability in the tender offer context. It approves the SEC's promulgation of Rule 14e-3 as read on its face, without a requirement of fiduciary duty. This decision represents not an abrupt detour, but a logical extension of recent case law governing insider trading. Equally importantly, it seems to stabilize the definition of tender offer-related insider trading liability. At the same time, it may provide a precedent for broadly interpreting the "reasonably designed to prevent" language outside the tender offer context.

The Tenth Circuit's so-called "removal" of the fiduciary duty requirement was actually a refusal to read such a requirement into Rule 14e-3 and reflects an appreciation of the uniqueness of tender offers and their potential for abuse by those without a fiduciary duty to the target company shareholders. Rule 14e-3 contains ample safeguards to ensure that those making decisions on the basis of legitimate market research are not penalized. The Tenth Circuit's reading of the Rule will help deter fraud perpe-

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136. *See, e.g.*, 17 C.F.R. § 240.13e-3(b)(2) (1993); 17 C.F.R. § 240.13e-4(b)(2) (1993); 17 C.F.R. § 240.14e-1 (1993); 17 C.F.R. § 240.14e-2(a) (1993); 17 C.F.R. § 240.15c2-6(a) (1993); 17 C.F.R. § 240.15c2-11(a) (1993); 17 C.F.R. § 240.15c2-12(a) (1993); 17 C.F.R. § 240.15g-8 (1993).

137. United States v. Chestman, 947 F.2d 551, 558 (2d Cir. 1991) (en banc), *cert. denied*, 112 S. Ct. 1759 (1992).

138. SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992).

139. *See* 17 C.F.R. § 240.14e-1 (1993).

140. *See* 17 C.F.R. § 240.14e-2 (1993).

141. 15 U.S.C. § 78 (1988 & Supp. IV 1992).

142. 978 F.2d 1162 (10th Cir. 1992).

trated by insider traders in the tender offer context without discouraging the legitimate dissemination of information.

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