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From *Texas Gulf Sulphur* to *Chiarella*: A Tale of Two Duties

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ABSTRACT

This short essay tells the story of two distinct journeys begun in SEC v. Texas Gulf Sulphur*—one dealing with insider trading, the other with corporate liability for false corporate publicity. The first involves the "equal access" principle planted therein and then harshly discarded by the Supreme Court twelve years later in* Chiarella v. United States*. My claim is that marketplace egalitarianism never had much traction in the period from* TGS *to* Chiarella*, and was largely dead by the time the Court officially extinguished it. By that time, it played mainly a boogeyman role. The second journey had a different fate: the flourishing of the fraud-on-the-market cause of action. But an important back story also takes us from* TGS *to* Chiarella *in the truncation of the corporation's affirmative duty to disclose, which was collateral damage from the Court's insider trading ruling. Though now mostly forgotten because of all that was swept away in* Chiarella*'s wake, landmarks along the way can be pieced together into an interesting story of legal archeology, with some contemporary relevance.*

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I. INTRODUCTION

THE Second Circuit's en banc decision in *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*[1] (hereinafter referred to as *TGS*) is well known for several important holdings. Perhaps the most celebrated (or condemned) holding accepted the Securities and Exchange Commision's (SEC) argument that corporate insiders have a duty to "abstain or disclose" from trading while in possession of material non-public information. The opinion makes a bold claim that the law in play (Rule 10b-5's antifraud prohibition) "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[2] From that comes a command of considerable breadth:

> [A]nyone 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.[3]

Another seminal holding in *TGS* interprets the language found in both the statute and rule prohibiting fraud "in connection with the purchase or sale of any security." As to that, the court squarely rejected privity as a limitation, saying that even when the corporation is not itself a purchaser or seller, it still owes a duty of truthfulness in any communication "reasonably calculated to influence the investing public."[4] That enlarged the scope of the prohibition to include all corporate communications on which investors are likely to rely, which later came to mean anything material that could foreseeably make its way into the hands of investors.[5]

Both of these were blockbuster rulings at the time, causing consternation in the business community because of the massive private liability risk that followed if every marketplace trader then had a right to out-of-pocket damages from either insider trading or false publicity, as *TGS* implied and class action plaintiffs soon started claiming.[6] But the two hold-

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1. *See generally* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc).

2. *Id.* at 848.

3. *Id.*

4. *Id.* at 862. The court says that it means publicity disseminated via the financial media.

5. *See generally In re* Carter-Wallace, Inc., Sec. Litig., 150 F.3d 153 (2d Cir. 1998) (discussing liability for misstatements in medical advertisements).

6. It provoked a powerful and eventually influential critique from Professor David Ruder, who later became Chairman of the SEC. *See generally* David S. Ruder, Texas Gulf Sulphur—*The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 Nw. U. L. Rev. 423 (1968). On Ruder's influence, see Douglas M. Branson, *Prescience and Vindication: Federal Courts, SEC Rule 10b-5, and the Work of David S. Ruder*, 85 Nw. U. L. Rev. 613, 619 (1991). As Branson notes, Ruder very early on foresaw the undisciplined expansion of both insider trading law and corporate liability for false publicity.

ings had different fates. Twelve years later, in *Chiarella v. United States*,[7] the Supreme Court rejected equality as an unrealistic, inefficient touchstone for insider trading liability, substituting a more conservative fiduciary breach duty standard in its place. Although the insider trading prohibition under Rule 10b-5 survived, it was more constricted.[8] Some seem to think that the ghost of *TGS* soon appeared to incite prosecutors, enforcers, and lower court judges to push back on the constriction and find clever ways of avoiding its fiduciary confines.[9] But as a formal legal matter, at least, insider trading law was put on a straight and seemingly narrower pathway.

By contrast, the abandonment of privity via the "reasonably calculated" standard has remained the law to this day. *TGS* thus gave impetus to a body of case law to accommodate private damage claims for false corporate publicity, eventually becoming the "fraud-on-the-market" cause of action blessed in 1998 by the Supreme Court in *Basic Inc. v. Levinson*[10] and dramatically reaffirmed by the Court as a matter of stare decisis in 2014.[11]

This brief Essay on *TGS* comments on these two journeys.[12] As to the latter, it will not attempt to tell the lengthy and complicated story of how fraud-on-the-market came to be. Instead, it focuses entirely on a somewhat buried (but potentially explosive) issue raised by the corporate liability portion of *TGS*: the corporation's affirmative duty to disclose material, non-public information in the absence of its own trading. Like the insider trading path, this one also stops at *Chiarella*, albeit only by

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7. *See generally* 445 U.S. 222 (1980).

8. *See generally* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1 (1982) [hereinafter Langevoort, *Fiduciary Principle*]. On how *Chiarella* came to be decided, see A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 931–34 (2003) [hereinafter Pritchard, *Powell and the Counterrevolution*].

9. Shorn of ghosts, I have told such a story, as have others from various points of view. *See* Donald C. Langevoort, *Words from on High About Rule 10b-5:* Chiarella's *History*, Central Bank's *Future*, 20 DEL. J. CORP. L. 865 (1995); *see generally* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315 (2009); Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999).

10. *See* 485 U.S. 224, 239 n.16 (1988). *Basic* also endorsed the *TGS* approach to the materiality of speculative information, using the "probability/magnitude" test for all fraud cases.

11. *See* Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2411 (2014).

12. I leave to elsewhere deeper exploration of the road to *TGS*. The roots of federal insider trading law go back to the SEC's seminal decision in *In re Cady, Roberts*, 40 S.E.C. 907 (1961), to the Supreme Court's *Capital Gains* case, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), which recognized a duty to disclose in face to face transactions, and even to the SEC's unease with broker dealer firms that tried to evade fixed commission rates by using insider tips as currency for order flow. On the latter, see generally Stanislav Dolgopolov, *Insider Trading, Chinese Walls, and Brokerage Commissions: The Origins of Modern Regulation of Information Flows in Securities Markets*, 4 J.L. ECON. & POL'Y 311 (2008). Useful contemporaneous assessments of early insider trading law include William Cary et al., *Insider Trading in Stocks*, 21 BUS. LAW. 1009 (1966) and Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulphur *Proceeding*, 51 VA. L. REV. 1271 (1965), both of which are cited in *TGS*.

implication. There is a strong and unappreciated connection among the corporate disclosure obligation, the rejection of privity, and the search for duty in insider trading cases. Though now mostly forgotten because of all that was swept away in *Chiarella*'s wake, landmarks along the way can be pieced together into an interesting story of legal archeology with some contemporary relevance.

II. INSIDER TRADING

TGS has long been tagged as an endorsement of an investor's right to expect equal access to information for trading purposes, which the Supreme Court later explicitly rejected in *Chiarella* when it said that "[w]e cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[13] But the story is much more complicated.

TGS surely does state that egalitarianism is the new norm, and if that is what was actually meant, the passionate embrace should not be all that surprising.[14] In 1968, the judiciary was at a high point in pursuing a broad, expansive common law style of securities law jurisprudence, commonly referred to as the new federal corporation law.[15] The Second Circuit had not initially been on board with this, but two far-reaching Supreme Court opinions (one of which gave a remarkably expansive meaning to fraud by investment advisers)[16] called for action. Under these marching orders, courts were entitled and expected to add on to statutory obligations

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13. Chiarella v. United States, 445 U.S. 222, 233 (1980). The Court did not cite *TGS* explicitly for this, but it did refer to the lower appellate court opinion that, in turn, borrowed the language from *TGS*.

14. As Steve Bainbridge points out in his criticism of *TGS* in this Issue, the key paragraph that promotes marketplace egalitarianism contains non sequiturs, overbroad language, and one-off citations, obscuring the inventiveness of the philosophy being promoted. *See* Stephen M. Bainbridge, *Equal Access to Information: The Fraud at the Heart of* Texas Gulf Sulphur, 71 SMU L. REV. (2018). Bainbridge thus concludes that the opinion was a fraud of its own, so that it and all the case law that followed were (and are) illegitimate. Though I agree that the bold proclamation of an egalitarian ideal and resulting disclosure duty was new to *TGS*, I disagree about the illegitimacy for reasons explained herein.

15. *See generally* Arthur Fleischer, Jr., *Federal Corporation Law: An Assessment*, 78 HARV. L. REV. 1146 (1965). Not all agreed that this was legitimate or healthy. *See, e.g.*, David S. Ruder, *Pitfalls in the Development of a Federal Law of Corporations By Implication Through Rule 10b-5*, 59 NW. U. L. REV. 185 (1964). For a thorough account of securities law jurisprudence in the Supreme Court and the Second Circuit during this formative period, see Adam C. Pritchard & Robert B. Thompson, *Securities Law in the Sixties: The Supreme Court, the Second Circuit, and the Triumph of Purpose over Text* (Michigan Law Sch. Soc. Sci. Research Network Elec. Paper Collection, Paper No. 18-004, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3119969 [https://perma.cc/JY5R-4N7G].

16. *See generally* Capital Gains Research Bureau, Inc., 375 U.S. 180. I am persuaded by Adam Pritchard that *Capital Gains* plays an especially important causal role in establishing the law of insider trading, including *TGS*, in part because it so roundly criticized a more cautious, interpretive approach by the Second Circuit. *See* A.C. Pritchard, *Launching the Insider Trading Revolution:* SEC v. Capital Gains Research Bureau, *in* RESEARCH HANDBOOK ON INSIDER TRADING 33 (Stephen M. Bainbridge ed., 2013). Separately, the Supreme Court had recently countenanced the implied private right of action in securities

based on purely purposive reasoning, even (or especially) in abrogation of textual or common law solutions to such problems. So, if Judge Waterman and his colleagues on the Second Circuit genuinely believed that egalitarianism best captured the purpose behind the antifraud provisions of the securities laws, they needed no text, precedent, or legislative history to fashion doctrine around it. The basic idea that the securities laws, including § 10(b) and Rule 10b-5, were meant to protect investors from being put or kept in the dark when the truth was available to those in the know is not an unfair reading of its legislative purpose or history.[17]

In fact, Waterman had already taken a giant step three years earlier when he held in *List v. Fashion Park, Inc.* that insiders had a 10b-5 obligation of affirmative disclosure when engaged in face-to-face securities transactions.[18] Any narrower view of duty, he says:

> contravenes the purpose of Rule 10b-5 in cases like this . . . which precludes not only the conveyance of half truths by the buyer which actually misled the seller, but, as well, failure by the buyer to disclose the full truth so as to put the seller in an equal bargaining position with the buyer.

The seeds of egalitarianism were thus planted. Then he signaled the expansion to trading in impersonal markets that was to come in *TGS* (which the common law refused to do because of lack of reliance), warning that "*the effect of adopting [the strict common law approach to reliance] would be automatically to exempt many impersonal transactions.*"[19] The opinion insists on a showing by the plaintiff of reliance on the nondisclosure, but then presumes reliance from the materiality of what was undisclosed in breach of duty. Analytically, that is the key step in seeing insider trading as fraud. Nor was this unbounded judicial inventiveness; less than a decade later, the Supreme Court would endorse that very same presumption.[20] All *TGS* did, then, was officially affirm the extension of *List*'s duty-based idea to exchange-based trading (impersonal transactions)—i.e., trading triggers a duty to disclose to all marketplace traders who are presumptively harmed by being deprived of the information the insider should have revealed.[21]

Nothing in *List* or *TGS*, however, suggests that Waterman was thinking about anything beyond the classic form of insider trading (or tipping) by corporate officers, directors, and key employees. So why the rhetoric of

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cases absent any express statutory foundation. *See* J.I. Case Co. v. Borak, 377 U.S. 426 (1964).

17. *See* Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1103–15 (1985).

18. *See* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965). *List* is cited in *TGS*, though not on the duty question.

19. *Id.* at 462 (emphasis added).

20. *See generally* Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972). On *Affiliated Ute* as an endorsement of the insider trading as fraud teachings of *TGS* and its progeny, see Pritchard & Thompson, *supra* note 15.

21. In other words, open market insider trading is not limited by privity either, a conclusion that links our two journeys. *See infra* Part II.

naked egalitarianism? Perhaps it was an expansion the judge really wanted to pursue. Or perhaps Waterman (or his clerk) wrote this paragraph without giving all that much thought to the implications of his over-enthusiastic dicta, intending mainly just to bless the SEC's effort—articulated in its seminal *Cady Roberts* decision—to define the duty to abstain or disclose by reference to the unfair exploitation of access to corporate secrets. That was how David Ruder read the opinion in his influential, contemporaneous criticism.[22]

This argument about provenance would be just an academic debate but for the suspicion that *TGS* and its egalitarian philosophy somehow survived the attempted execution in *Chiarella* and survives—or haunts—to this day. My assessment is different. Even if it is truly what the *TGS* majority wanted to impose, I doubt that the egalitarianism rhetoric ever had that much influence over insider trading doctrine, except as a rallying cry for its critics. It dissipated quickly as a norm. What had staying power instead was the SEC's considerably different way of thinking about the insider trading prohibition in *Cady Roberts*, which was about duty arising from abuse of status, not mere possession. The twelve years between *TGS* and *Chiarella* made that abundantly clear. The disdain for egalitarianism that continued—even increased—over the course of the decade was in response to what Wall Street strategically propped up as the boogeyman of a naïve and overbroad philosophy, not how the law of insider trading was being applied.

My point here is not to defend either the court's opinion in *TGS* or the underlying assumption that insider trading is fraud, which is the real sleight of hand accomplished by both *Cady Roberts* and *TGS*. I think there is a rational economic basis for prohibiting insider trading,[23] but I have long conceded that it is not deceptive in the way we today insist on for 10b-5 liability.[24] It involves constructive or equitable fraud, perhaps, but not deceit, and it plays more of an expressive, political role in securities regulation than one driven by the teachings of financial economics.[25] So *TGS* might well be taken to task for an excess of zealous activism if we are to judge it by today's more conservative standards for what it takes to declare a practice unlawful under Rule 10b-5.[26] Judged as of its time, however, it fit the zeitgeist of federal corporation law very well. Not a single judge in *TGS*—majority, concurrence, or (otherwise apoplectic)

22. Ruder says that notwithstanding the egalitarian dicta, "[m]ost probably . . . the majority did not intend to establish a 'possession' test." Ruder, *supra* note 6, at 439 n.88. He notes in support of his reading that the language in Waterman's opinion that follows after the jarring dicta turns to a discussion of special access, not mere possession.

23. For a good, recent analysis, see Merritt B. Fox, Lawrence R. Glosten & Gabriel V. Rauterberg, *Informed Trading and Its Regulation*, DEL. J. CORP. L. (forthcoming 2018).

24. *See generally* Langevoort, *Fiduciary Principle*, *supra* note 8, at 8.

25. *See* Donald C. Langevoort, *Rereading* Cady, Roberts: *The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319 (1999) [hereinafter Langevoort, *Rereading*].

26. Similarly, see Richard A. Epstein, *Returning to Common-Law Principles of Insider Trading After* United States v. Newman, 125 YALE L.J. 1482, 1508–10 (2016).

dissent—gave any attention to the argument against declaring insider trading fraudulent, even though it had repeatedly been made by practitioners and academic commentators.[27] And in the forty years since, no justice or judge has either. That says something about the strength of the desire to reach the perceived abuses, and not that *TGS* cast some invisibility potion over the doctrinal difficulties of using Rule 10b-5 to do so.

But *TGS* and its egalitarian language are just our journey's starting point. In terms of both political economy and administrative practice, the years 1968–1980 were a fascinating time period. The SEC was dominated by Republicans for eight of those years. Watergate, surprisingly, gave the SEC enforcement apparatus an unexpectedly high profile,[28] and the drama and publicity surrounding insider trading cases no doubt whet the appetite of the staff and commissioners to bring them more and more aggressively (though the real publicity payoffs to the SEC from this aggression would not come until the 1980s). These were the years when the Commission first had the inkling that the campaign against insider trading gave brand recognition to U.S.-style securities regulation as "the investors' champion."[29]

This political background is important. Cases like *TGS* and the many that soon followed provoked concern among corporate executives, no doubt, but mixed feelings on Wall Street. A rule that corporate insiders are subject to a strict abstain or disclose obligation might actually be attractive to Wall Street.[30] If the executives and their cronies could not trade, professional traders would be next in line to exploit any available informational advantages. But that political equilibrium was an uneasy one, as we are about to see, especially when enforcers' attention turned from corporate information to market information.

A. Early Cases

The earliest post-*TGS* insider trading cases were a mix of SEC enforcement actions and private class actions, wherein we can indeed find smatterings of evidence that market egalitarianism was a serious philosophy.[31] The class actions derived from a joinder of the two parts of the Second

27. *See* William H. Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 Colum. L. Rev. 1361, 1381 (1965). The argument has been repeated without success, including in arguments made in the Supreme Court's most recent insider trading case, *Salman v. United States*. *See* Brief for Petitioner at 21–23, Salman v. United States, 137 S. Ct. 420 (2016) (No. 15-628), 2016 WL 2732058.

28. *See* Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 448 (3d ed. 2003).

29. *See* Langevoort, *Rereading*, *supra* note 25.

30. *See, e.g.*, David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & Econ. 311 (1987).

31. Very shortly after *TGS*, the Second Circuit decided *SEC v. Great American Industries, Inc.*, 407 F.2d 453 (2d Cir. 1968), with dicta in concurring opinions by three judges—including Judge Waterman—giving wide scope to the duty to disclose. This is the best evidence that the egalitarian principle was intended to be the basis for insider trading law.

Circuit's opinion: insiders breach a duty to abstain or disclose and that duty is owed to all marketplace traders. Thus, each trader should be compensated for out-of-pocket damages reflecting losses that would have been avoided had the insider fully disclosed. Defendants responded by insisting on privity (liability only to the actual counterparty), pleading that damages under the broader approach would dwarf the profits they made and be draconian. So, much was at stake.

The most important of these early cases arose out of trading in stock of the Douglas Aircraft Corporation based on tips about an unexpected decline in earnings that emanated from Merrill Lynch, which was acting as an underwriter for a registered distribution of Douglas debentures. These facts generated two SEC administrative proceedings,[32] a class action for damages,[33] and a separate case against Douglas for breaching an affirmative duty to disclose.[34] As to the former, the Second Circuit hardly paused before concluding that both tippers and tippees were liable for all appropriate relief: the conduct of each is equally reprehensible, and as *TGS* had said, all that is necessary is that the tippee came to possess inside information. In the class action, it remanded on the question of remedy after rejecting defendant's privity argument, which seemed to endorse plaintiff's theory merging insider trading with fraud-on-the-market.[35]

In the administrative proceeding involving one of the tippees, Investors Management Company, the SEC was a bit more careful to elaborate, and in so doing drew far more from *Cady Roberts* than from *TGS*. For the first time, it set out the elements of an insider trading case in terms of not only materiality, but also duty, knowledge, and the misuse of the information. As to duty, the majority's articulation was that:

> [O]ne 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 antifraud provisions.[36]

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32. *See generally In re* Inv'rs Mgmt. Co., 44 S.E.C. 633 (1971); *In re* Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933 (1968).

33. *See generally* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974). Also important from the same year was an unrelated case, *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974), which extended the insider trading prohibition to situations where the insider buys stock in the shares of a company with which he has no relationship because he knows of an action by his employer or client that will affect the other company's stock price.

34. *See generally* Fin. Indus. Fund, Inc., v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973) (per curiam).

35. In *Shapiro*, the court did urge flexibility by the trial court on the remedy issue. *See* 495 F.2d at 242. Eventually, the Second Circuit settled on an approach to damages that effectively limited class recovery to the insiders' profits, which dampened plaintiffs' enthusiasm for such cases. *See* Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 168–73 (2d Cir. 1980).

36. *In re Inv'rs Mgmt. Co.*, 44 S.E.C. at 641–51.

That is consistent with *TGS*, to be sure, but starts to draw a more elaborate framework for liability than simple possession. However, *Investors Management* is best known for a concurrence by Commissioner Richard Smith, who explicitly raised doubts about the impact of too much market egalitarianism on smoothly functioning markets. He thus offered an even more refined test, with liability only when the tippee acts

> knowing or having reason to know that the material non-public information became available to them in breach of a duty owed to the corporation not to disclose or use the information for non-corporate purposes. Such knowledge, in effect, renders the tippee a participant in the breach of duty when he acts on the basis of the information received.[37]

Readers familiar with *Chiarella*, and the subsequent *Dirks* decision, will note how close this is to how the Supreme Court eventually framed tipper-tippee law, although Smith (unlike Justice Powell later on) denied in his concurrence that fiduciary duty should be the *only* kind of duty to the corporation that might be breached so as to create tippee liability.[38]

So if some seeds of egalitarianism may have been planted by *TGS*, they bore surprisingly little fruit. Duty was clearly becoming status-based, not possession-based. To be sure, there were still echoes to be found in some unofficial SEC staff remarks and aggressive enforcement actions that were settled, not litigated.[39] But at its highest levels, at least, the SEC had come to realize that a broad enforcement challenge to common information-gathering behaviors by analysts, traders, and others was neither a sustainable litigation strategy nor particularly good policy or politics. In 1976, SEC Commissioner Philip Loomis (who as General Counsel had argued *TGS* in the Second Circuit) signaled this recognition in an important speech, saying, "[T]he concept of equality of information goes too far. It not only lacks an adequate basis in the law of fraud but is also an impractical standard."[40]

B. The Proposed Federal Securities Code

Also worth some mention as a matter of intellectual legal history on insider trading in the 1970s is the American Law Institute's Federal Securities Code, designed to replace the statutory and case law that had

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37. *Id.* at 650 (internal citations omitted).

38. He said that "purloined" information would satisfy the test because "[a] duty not to steal or knowingly receive stolen goods or exercise dominion over goods known to be owned by others exists toward the corporation even without the presence of a special relationship." *Id.* at 650 n.2.

39. This is discussed in an important law review article, which noted that the case law had not yet taken the *TGS* rhetoric to its logical conclusion, notwithstanding occasional noises in that direction. *See* Arthur Fleischer, Jr., Robert H. Mundheim & John C. Murphy, Jr., *An Initial Inquiry into the Responsibility to Disclose Market Information*, 121 U. Pa. L. Rev. 798 (1973).

40. Philip A. Loomis, Jr., Comm'r, Sec. Exch. Comm'n, Some Reflections on Rule 10b-5 and Market Information 12–13 (May 6, 1976) (transcript available at https://www.sec.gov/news/speech/1976/050676loomis.pdf [https://perma.cc/6EXB-QJVF]).

grown so fast with a carefully crafted statute. The monumental effort was led by Louis Loss of Harvard and Milton Cohen, the architect of the SEC's Special Study of the Securities Markets, out of which came the first calls for codification.[41] They were supported by much of the legal establishment, including Judge Henry Friendly of the Second Circuit.[42] The effort would ultimately fail, but for a time it reflected what many considered the best available thinking about securities regulation.

Obviously, insider trading was a challenge for the Code's drafters, who squarely rejected any "universally applicable theory of 'market egalitarianism.'"[43] Following David Ruder's prodding, they read *TGS* (and the state of the law) narrowly, treating the egalitarian ideal as loose dicta. Thus, they gave a fairly conventional scope as to the definition of insider and created a knowledge-based test for tippee liability. Their express prohibition stopped with that, though they did say that in especially egregious cases of abuse by "quasi-insiders," a back-up general antifraud prohibition *might* be invoked. Here, again, we see important sources of law moving even further away from any spell *TGS* might have cast.

C. The Tender Offer Conundrum

By 1968, the takeover wars were booming, and in the same year, Congress passed the Williams Act amendments to the Securities Exchange Act. New § 13(d) required disclosure by bidders of acquisitions of securities on the open market or otherwise when beneficial ownership passed a five percent threshold. The implication, of course, was that up to that point, issuers could buy stock secretly, even when they had private inside knowledge of their own plans and intentions. That alone—as the Second Circuit soon[44] and the Supreme Court later pointed out—indicated that equal access would never work as a coherent theory of liability. The SEC commenced a major special study of the role of institutional investors in the securities markets, confirming after considerable analysis that the corporate takeover setting (including the controversial practice of "warehousing"[45]) was too challenging to employ insider trading rules based simply on egalitarian principles,[46] calling instead for rulemaking under

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41. For comments on the Code project, see Donald C. Langevoort, *The Education of a Securities Lawyer*, 80 Nw. U. L. Rev. 259, 265–67 (1985) [hereinafter Langevoort, *Education*] (reviewing Louis Loss, Fundamentals of Securities Regulation (1983)).

42. Friendly's role in securities cases was interesting and profound, partly based on a close relationship to Louis Loss. *See* Margaret V. Sachs, *Judge Friendly and the Law of Securities Regulation: The Creation of a Judicial Reputation*, 50 SMU L. Rev. 777, 794–808 (1997).

43. Fed. Sec. Code § 1603 cmt. 3(d) at 539 (Am. Law Inst., Proposed Official Draft 1978).

44. And the Second Circuit so held very shortly after *TGS*. *See* Gen. Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1968).

45. Warehousing is the deliberate communication of the bidder's intent to launch the tender offer to traders whose purchases would put more of the stock in bidder-friendly hands. *See* Fleischer, Mundheim & Murphy, *supra* note 39, at 811.

46. *See id.* at 811–13.

the broader regulatory authority given to the SEC in § 14(e) by additional Williams Act amendments in 1970.

Ultimately, that happened, though not until after *Chiarella*. The story is worth noting, however. At first glance, the rule as adopted (and more so as initially proposed) was very broad and seemingly in sync with the egalitarian approach found in *TGS*. Read more closely, however, Rule 14e-3 seems more attendant to the unique set of interests at stake in hostile takeovers than trading practices generally, and it is filled with exceptions that its authors in the Division of Corporation Finance saw as countering the lingering egalitarian leanings of the Enforcement Division.[47] Warehousing was forbidden, but otherwise the rules were drawn to assure that they did not interfere with common market practices. The final proposal also created an explicit "Chinese Wall" defense for multiservice financial institutions, more protective than what had been articulated by the Commission in an amicus brief a few years earlier.[48]

D. *Chiarella*

All of the underlying angst about the right grounding for insider trading law came together in the prosecution of Vincent Chiarella, which commenced in early 1978. As is well known, he was an employee at a financial printer who was able to determine the names of about-to-be targets of a surprise takeover bid from yet nonpublic disclosure documents being printed on behalf of the bidders. He bought target stock and options and profited handsomely for someone of his means. This was a path-breaking *criminal* insider trading case, which produced a good bit of shock and awe on Wall Street among those who, from time to time, received market-related secrets.

The Second Circuit's opinion affirming Chiarella's conviction is interesting, as it shows how much the intervening decade had altered the understanding of what constitutes insider trading.[49] The opinion does start with a homage to *TGS*, quoting the egalitarian dicta and the broad liability standard. But, it then fashions a revised test as to who is covered

47. *See* Interview with Richard Rowe, former Dir. of the Div. of Corp. Fin., Sec. Exch. Comm'n, in Washington, D.C. (May 24, 2004) (transcript available at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/oral-histories/rowe052404Tanscript.pdf [https://perma.cc/V2NK-6DBW]).

48. The issue in *Slade v. Shearson Hammill & Co.*, Fed. Sec. L. Rep. (CCH) ¶ 94,329 (S.D.N.Y. 1974), was whether a securities firm could use the existence of a "Chinese Wall" as a legal defense when accused of violating a duty to its customers by recommending purchases contrary to inside information held in other departments of the firm. The district court said no, relying heavily on the rhetoric in *TGS*. In an amicus brief on appeal, the SEC largely agreed, urging the use of such walls, but simply as a prudential matter; the wall would not necessarily relieve the firm of liability for its ill-founded recommendations. In contrast, Rule 14e-3 made the wall an explicit defense to the insider trading itself. For a discussion, see Norman S. Poser, *Chinese Wall or Emperor's New Clothes? Regulating Conflicts of Interest of Securities Firms in the U.S. and the U.K.*, 9 MICH. Y.B. INT'L LEGAL STUD. 91, 108 (1988).

49. *See generally* United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

under Rule 10b-5, stating: "Anyone corporate insider or not *who regularly receives* material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."[50] This was status-based, not simple possession, and thus far closer to *Cady Roberts* than *TGS*. To stress the limitation, the court said that this principle is an effort to prevent abuse—wrongfully exploiting that status of regular access to information by knowing that the information was not theirs for the taking. In support, the majority invoked the Federal Securities Code as allowing the stretch to reach such an "egregious" case of misconduct. Summarizing, and saying exactly the opposite of what the Supreme Court would later say it said, the opinion emphasizes that "[w]e are *not* to be understood as holding that no one may trade on nonpublic market information without incurring a duty to disclose."[51]

The Second Circuit's approach, then, was far from the simple norm *TGS* had articulated or that the Supreme Court later ascribed to it. But when the case went up to the Court, the defense side (aided by a large segment of the Wall Street community) portrayed it as a warmed-over *TGS* and a naïve and careless threat to how markets work. And in a moment now largely forgotten, the Justice Department chose not to defend the Second Circuit's philosophy or approach. As the *Chiarella* case was being litigated below, the initial briefing and arguments were in line with the flexible access-equals-duty approach of prior case law, which had persuaded the Second Circuit. But when the Solicitor General's office took over the case, the argument shifted considerably. The two primary lawyers on the case were Stephen Shapiro and Kenneth Geller, now lions of the Supreme Court bar and authors of the standard treatise on Supreme Court practice. Up until just before *Chiarella*, their boss at the Solicitor General's office was Frank Easterbrook, who would soon have much to say about insider trading theory,[52] and presumably guided their thinking even after his departure. Shapiro and Geller essentially dropped all references to duty as theretofore understood and explicitly disavowed any support for market egalitarianism.[53] Instead, they essentially bet all the marbles on treating Chiarella's behavior as a misappropriation, and hence a fraud, because it deceived the source of the information and because misappropriation itself triggers a duty to disclose. That bet failed on

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50. *Id.* at 1365 (emphasis added).

51. *Id.* at 1366 (emphasis added). None of this, however, was enough to avoid a dissenting vote from Judge Meskill, who wanted to confine *TGS* to its original scope, shorn of any hint of market egalitarianism. To be fair to the Supreme Court, the Second Circuit does contradict itself in both affirming and denying egalitarianism. However, the test it applies is clearly not simple egalitarianism, but rather the fashioning of a federal law duty corresponding to the category of persons whose misuse of confidential information made available to them can be characterized as abusive, i.e., a natural extension of *Cady Roberts*, if not *TGS*.

52. *See generally* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 S. Ct. Rev. 309 (1981).

53. *See* Brief for the United States at 70 n.48, Chiarella v. United States, 445 U.S. 222 (1980) (No. 78-1202), 1979 WL 213521.

procedural grounds, though of course the former version of the misappropriation theory did prevail in later cases and, eventually, the Supreme Court.[54]

In sum, the egalitarianism expressed in *TGS* was long gone by the time Justice Powell wrote the Court's opinion in *Chiarella*. The case law had moved on to look for firmer grounding; Easterbrook, Shapiro, and Geller wanted a completely fresh start. Powell is thus wrong when he says that petitioner's conviction could not be affirmed without resort to equal access, but there were no advocates before him pushing for a capacious form of duty or pointing out the consequences of his "fiduciary duty only" test.[55] This had implications beyond insider trading, as we are about to see.

So this journey stops, but not really. As noted earlier, the spirit of *TGS* did return to push against the newly narrowed insider trading prohibition, and the nearly four decades since *Chiarella* have shown much more expansion than limitation in insider trading doctrine. Much of this came from the embrace of misappropriation, as the Easterbrook-Shapiro-Geller team had hoped. While misappropriation can be seen as a property rights-based construct, its application also brought back into the federal prohibition a great deal of misconduct that touches the nerve of egalitarianism's believers. Ghostly or not, some remnants of the old egalitarianism exist to this day, mainly in portions of insider trading law outside the control of the federal courts, where a handful of true believers can still be found. This includes the SEC's Regulation FD, state-law litigation like the New York State Attorney General's "Insider Trading 2.0,"[56] and statutory reform proposals popping up from time to time in Congress that harken back to the old idealism.[57]

Whether one prefers egalitarianism in insider trading regulation, Powell's fiduciary duty test, no regulation, or something in between, depends on a host of beliefs—about fairness, market efficiency, property rights, the economics of adverse selection, due process, statutory interpretation, judicial activism, and much more—that are well beyond the scope of this Essay. *TGS* may reflect an excess of activism, but the reaction in

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54. *See generally* United States v. O'Hagan, 521 U.S. 642 (1997).

55. That would be left to the dissenters, Chief Justice Burger and Justices Blackmun and Marshall. The Blackmun-Marshall dissent was very much a continuation of the Second Circuit's wrongfulness approach, given a bit more intellectual definition and heft via an elaboration by Victor Brudney in a widely cited law review article. *See generally* Victor Brudney, *Insiders*, *Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979). To be precise, the majority in *Chiarella* did not reject the possibility that there might be other bases (i.e., misappropriation) for the duty to disclose to other marketplace traders, but to this day that possibility has not been taken up directly.

56. These are efforts to attack institutional practices that promote unequal access to material information. On Insider Trading 2.0 and Reg FD, see DONALD C. LANGEVOORT, SELLING HOPE, SELLING RISK: CORPORATIONS, WALL STREET, AND THE DILEMMAS OF INVESTOR PROTECTION 82–84 (2016) [hereinafter LANGEVOORT, SELLING HOPE]; Fox, Glosten & Rauterberg, *supra* note 23.

57. *See, e.g.*, S. 702, 114th Cong. (2015) (introduced by Senators Reed and Menendez).

Chiarella isn't a shining example of judicial conservatism either: it ignores the deception requirement conundrum the same as *TGS* did, cites *Cady Roberts* as if thoroughly supportive of its decision, anchors without any textual justification on a state common law principle (fiduciary duty) that otherwise had been rejected as a federal securities fraud touchstone, and then promotes that principle as the exclusive source of duty, which it never was in the common law. All this makes the limiting fiduciary principle look more grounded in authority than it really was.[58] But to me, this is just how judges move indeterminate law in the direction they see fit. *TGS* and *Chiarella* are each the product of the perceived judicial norms of its time.

III. THE CORPORATION'S AFFIRMATIVE DUTY TO DISCLOSE

The portion of *TGS* that abandons any privity requirement does not speak in terms of fashioning federal corporation law, but instead just of fleshing out the meaning of the words "in connection with the purchase or sale of a security" found in both § 10(b) and Rule 10b-5. But it is very much an extension of the duty-based thinking expressed in the first part of the opinion.[59] It effectively declares that issuers owe a duty of truthfulness to all marketplace traders simply because the publicity in question is reasonably calculated to influence them and strongly implies what the business community feared: those to whom the duty is breached have a right to sue for out-of-pocket damages. In so doing, and to the consternation of Judge Henry Friendly, whose concurring opinion in *TGS* is almost as famous as the majority's, the court refused to place any state of mind limitations (i.e., requiring scienter) on the aggressive holding. It is probably fair to say that the reaction to the absence of limitations in this portion of *TGS* started the groundswell—again, both intellectual and political—that finally provoked the Supreme Court to turn away in securities cases from expansiveness in the mid-1970s and substitute a more for-

58. A fair reading of *Chiarella* is that it imposes the fiduciary principle not out of ignorance of the common law of fraud, but instead out of the conservative instinct that when doctrine is lacking in textual authority, it should be applied narrowly. This principle invites Congress (or perhaps the SEC) to undertake any desired expansion, but not judges. Powell's deep understanding and appreciation for fiduciary duty in the business setting made him willing to tolerate that scope to a nontextual body of insider trading, law but not want to venture any further into inventive duty-creation that might threaten the free functioning of the financial markets. *See* Pritchard, *Powell and the Counterrevolution*, *supra* note 8, at 931–34. I also think he would have been reluctant to gut insider trading law because of the extent to which it had taken on an expressive function in countering perceptions of capital markets in the United States dominated by irresponsible greed. *See* Donald C. Langevoort, *"Fine Distinctions" in the Contemporary Law of Insider Trading*, 2013 COLUM. BUS. L. REV. 429, 432–33 (2013).

59. Duty in tort law addresses when and why some act by the defendant requires compensation to the victim. As to fraud, see John C.P. Goldberg, Anthony J. Sebok & Benjamin C. Zipursky, *The Place of Reliance in Fraud*, 48 ARIZ. L. REV. 1001, 1003 (2006). In cases of fraudulent misrepresentation, courts generally say that no preexisting duty is needed to grant standing to a victim so long as the *TGS* test is satisfied. *See* Deutschman v. Beneficial Corp., 841 F.2d 502, 508 (3d Cir. 1988).

malist/textualist style of judging.[60]

Yet notwithstanding that eventual turn away from a federal common law of corporations, the reasonably calculated standard survived and flourished. Here, again, *TGS* is just a starting point; the phrase reasonably calculated is actually quite ambiguous. This phrase could connote that liability follows only if the issuer had some desire or purpose to mislead investors.[61] Later cases would reject that, however, in favor of insisting only that reliance by investors be foreseeable given the medium of dissemination that was chosen.[62] *TGS* thus opened the door to the emergence of the fraud-on-the-market lawsuit that the Supreme Court blessed in *Basic* amidst all the conservative retrenchment that was otherwise going on. But I have written elsewhere about how and why that might have occurred and need not repeat myself here.[63]

For now I am more interested in what happened to the law relating to a crucial question of that time: when, if ever, does the issuer have an affirmative duty to disclose material information in its possession? Even before *TGS*, the law had come to the view that the issuer trading in its own shares generally does have a duty to abstain or disclose, much the same as its insiders,[64] so that issuer repurchases are impermissible unless the company has revealed material good news in its possession (an idea much more coherent with *TGS* than *Chiarella*). But what if there was no trading by the issuer? While the en banc opinion does not have to address this, the companion private actions did, posing the question of whether TGS had a duty to correct rumors about the mineral discovery floating about in the marketplace.[65]

The opinion in *TGS* did say enough to lead observers to see a general duty to disclose looming, if not fully fledged, as footnote 12 said that issuers can delay disclosure for business reasons, which implied that they

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60. *See* Branson, *supra* note 6, at 614.

61. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 707 (8th ed. 2016).

62. I do still wonder what would have happened had a more purpose- or motive-based interpretation of reasonably calculated taken hold. For a case that might be read as imposing such a limitation, see Ont. Pub. Serv. Emps. Union Pension Tr. Fund v. Nortel Networks Corp., 369 F.3d 27 (2d Cir. 2004) (denying standing to purchasers of the stock in JDS Uniphase to sue Nortel for misstatements about its own financial condition even though the misstatements might have altered the total mix of information about JDS, which was a major supplier to Nortel); *see also* ECA & Local 134 IBEW Joint Pension Tr. v. JP Morgan Chase Co., 553 F.3d 187, 203 (2d Cir. 2009).

63. *See generally* Donald C. Langevoort, Basic *at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151. Key to the story is the work of two conservative academics, Frank Easterbrook and Daniel Fischel, who were very supportive of fraud-on-the-market because of its promise to substitute the use of financial economics tools for the more subjective assessments ordinarily made by judges and juries.

64. *See* Mark J. Loewenstein & William K.S. Wang, *The Corporation as Insider Trader*, 30 DEL. J. CORP. L. 45 (2005). There are occasional lingering doubts about this, though they have not undermined the general principle. *See* Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1657–60 (2004).

65. *See* Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 100 (10th Cir. 1971).

would have to disclose without such reasons.[66] So did a number of other cases,[67] albeit always in dicta, including the one coming out of the McDonnell Douglas matter noted earlier.[68] Such a disclosure obligation would be coherent with the spirit of equal access, because prompt disclosure is a principal mechanism by which market prices could stay close to fundamental value for the benefit of all traders,[69] and makes ample policy sense (as the footnote in *TGS* suggested) so long as there was some business judgment discretion given to issuers to keep secrets when there was a compelling competitive need for secrecy. But surprisingly, this never ripened into an obligation, although it did spawn the articulations of two narrower affirmative disclosure duties—the "duty to correct" and the "duty to update"—both of which survive to this day.[70]

Although it was not entirely clear at the time, *Chiarella* was once again a hard stop to what *TGS* began. The holding there in the insider trading context is that no duty exists simply because possession extends to *all* forms of the duty to disclose. Fiduciary obligation is of no help because the issuer itself has no fiduciary duty to disclose when it is not trading.[71] Any doubt about this that might have lingered in the courts was then finally disposed of, ironically, in a footnote in *Basic Inc. v. Levinson*, squarely indicating that nontrading issuers have no duty arising from the mere possession of material nonpublic information.[72]

My assessment here is much the same with respect to the insider trading narrative—the law could and should have evolved differently. To use a limited, truncated vision of fiduciary duty as the only source of a duty to disclose effectively says that corporate managers can keep secrets that harm investors even when the secrecy is simply to avoid embarrassment, blame, or loss of the perquisites of power. That has not set well with the courts, creating a "muddled" case law, as courts have to reach to the amorphous half-truth doctrine and other limited duty theories in an effort

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66. So read by David Ruder in his influential criticism. *See* Ruder, *supra* note 6, at 442–44.

67. Especially *Goldberg v. Meridor*, 567 F.2d 209, 221 n.10 (2d Cir. 1977), which was the Second Circuit's response to *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (rejecting breach of fiduciary duty as a form of deception under 10b-5). The SEC was also strongly suggesting an affirmative duty to disclose. *See* Timely Disclosure of Material Corporate Developments, Securities Act Release No. 5092, Securities Exchange Act Release No. 8995, Investment Company Act Release No. 6209, [1970–71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,915 (Oct. 15, 1970).

68. *See* Fin. Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 521 (10th Cir. 1973).

69. For a thorough review of the case law as of the eve of *Chiarella* and a recommendation that such a duty be recognized, see generally Jeffrey D. Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979).

70. *See* COX ET AL., *supra* note 61, at 723–24. On their derivations, see Bauman, *supra* note 69, at 963–72.

71. For a more contemporary statement of the limited fiduciary duty of candor, see generally Malone v. Brincat, 722 A.2d 5 (Del. 1998).

72. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 239 n.17 (1988).

to get better results.[73] The result has been inconsistency, at best, and too many troubling results, at worst. Here, too, I think we would have been better off letting the law inspired by *TGS* run its course, working incrementally toward a flexible, coherent duty that would put more pressure on issuers to disclose promptly when their disinclination to do so lacks a true business purpose.

IV. CONCLUSION

The fast-developing jurisprudence of Rule 10b-5 was dominated by the search for a theory of duty suitable for the modern capital markets for which older notions of privity were unsuitable. In *Chiarella*, the Supreme Court truncated two doctrinal journeys for which *TGS* might be seen as a starting point—one on the scope of the insider trading prohibition, the other on the public corporation's affirmative duty to disclose. For each of these, my reaction is the same: while what *TGS* said or implied was overbroad and needed substantial refinement, that work soon began and was in progress over the twelve years in between the two decisions. Securities law would have been better off, I suspect, had both journeys been permitted to continue without the scuttling.

73. *See* Langevoort & Gulati, *supra* note 64. The U.S. approach is not in sync with the rest of the world. *See generally* Marc I. Steinberg, *Insider Trading, Selective Disclosure, and Prompt Disclosure: A Comparative Analysis*, 22 U. PA. J. INT'L ECON. L. 635 (2001).