
Michael T. Raymond

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VALIDITY CHALLENGES TO SEC RULE 14e-3

MICHAEL T. RAYMOND*

What we see is a relatively new phenomenon in which investment bankers, institutions, arbitrageurs, accounting firms, public relations firms and law firms join together in takeover activities. And in which enormous sums of money are in the balance. This certainly raises the issue of an increased risk not only of insider trading, but of manipulation... Since takeovers have provided the major opportunity for insider trading to occur, that indicated to me that there’s a structural problem in our system that needs to be addressed. By structural problem, I mean that a window of opportunity exists in a takeover situation in which a select number of people know beforehand that a takeover attempt is about to occur. It’s from that that the current abuses flow.

Remarks of John J. Phelan, Jr., Chairman of the New York Stock Exchange, in the aftermath of the Ivan Boesky affair.¹

INTRODUCTION

The proliferation of takeover activity, and in particular tender offers, was a well-known phenomenon of the 1980s.² Equally well-

* L.L. M. (Securities Regulation), Georgetown University Law Center; J.D., The John Marshall Law School; M.S.A. (Accountancy), DePaul University Graduate School of Business, B.A., DePaul University. Mr. Raymond is practicing as a corporate and securities specialist with Lewis, White & Clay, P.C., Detroit, Michigan. He is a member of the bars of Michigan, District of Columbia and Colorado.


². According to the 1987 Senate Report:
[between 1981 and 1986 the number of merger transactions nearly doubled from 2,326 to 4,084. The reported value of transactions nearly tripled during the same period from $67.2 billion in 1981 to $192.9 billion in 1986. The average transaction value, where transaction value was disclosed, almost doubled from 1981 to 1986. The average transaction value in 1981 was $55.5 million,
publicized were the insider trading scandals associated with numerous takeover efforts.\(^3\) Whether the decade of the 1990's will be similarly scandalized is, of course, an open question.

The Securities and Exchange Commission's ("SEC") primary antifraud tool\(^4\) to combat insider trading in the tender offer context is Rule 14e-3.\(^5\) This rule was adopted pursuant to the specific

whereas by 1986 it has increased to $104.4 million. Transactions over $1 billion grew four times in number and three times in dollar value, capturing over 34 percent of total mergers and acquisitions value in 1986. There were 8 transactions over one billion dollars in 1981, whereas, by 1986 there were 29 in excess of one billion dollars. While hostile or contested tender offers represent a small fraction of all transactions, they represent a significantly larger part of the value of these transactions. According to a Congressional Research Service study requested by the Committee, contested tender offers represent only 2.8 percent of the number of transactions but 44.4 percent of the value of all mergers and acquisitions, for which the value of transactions was reported.

\(^{Id.}\) at 9.


5. 17 C.F.R. § 240.14e-3 (1988). Rule 14e-3 provides as follows:

(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 [Exchange] 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 or any 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.

(b) A person other than a natural person shall not violate paragraph (a) of this section if such person shows that: (1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and (2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a), which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(c) Notwithstanding anything in paragraph (a) to the contrary, the following transactions shall not be violations of paragraph (a) of this section: (1) Purchase(s) of any security described in paragraph (a) by a broker or by another agent on behalf of an offering person; or (2) Sale(s) by any person of any security described in paragraph (a) to the offering person.
rulemaking authority of section 14(e)\(^6\) and the general rulemaking authority of section 23(a)(1)\(^7\) of the Securities Exchange Act of 1934 ("Exchange Act").\(^8\) Although the rule, which became effective on October 14, 1980,\(^9\) is over nine years old, it has failed to receive universal recognition as a valid exercise of the SEC's rulemaking authority. In fact, several recent cases highlight the unsettled debate

(d)(1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the [Exchange] 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, (i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer; (ii) To the issuer whose securities are sought to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or (iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

(d)(2) The persons referred to in paragraph (d)(1) of this section are: (i) The offering person or its officers, directors, partners, employees or advisors; (ii) The issuer of the securities sought to be sought by such tender offer or its officers, directors, partners, employees or advisors; (iii) Anyone acting on behalf of the persons in paragraph (d)(2)(i) or the issuer or persons in paragraph (d)(2)(ii); and (iv) Any person in possession of material information relating to a 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 any of the above.

Id.

6. 15 U.S.C. § 78n(e) (1988). Section 14(e) provides as follows:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request for tender, 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.

Id.

7. 15 U.S.C. § 78w(a)(1) (1988). Section 23(a)(1) provides, in pertinent part, as follows:

The Commission, the Board of Governors of the Federal Reserve System, and the other agencies enumerated in section 78c(a)(34) of [the Exchange Act] shall each have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this title for which they are responsible or for the execution of the functions vested in them by this chapter, and may for such purposes classify persons, securities, transactions, statements, applications, reports, and other matters within their respective jurisdictions, and prescribe greater, lesser, or different requirements for different classes thereof.

Id.

9. See infra notes 20 and 38 (history of the enactment).
over the rule's validity.10

This article reviews the legislative premise and background of Rule 14e-3. It examines the rule when juxtaposed against its Exchange Act antifraud counterpart, Rule 10b-511 promulgated pursuant to section 10(b)12 of the Exchange Act, and analyzes the basis for an in pari materia construction of the two antifraud provisions. It considers various lines of attack upon the rule's validity and evaluates the SEC's defenses to those attacks. Finally, the article recommends a course of action to establish the rule's legal certainty where uncertainty presently exists.

I. WILLIAMS ACT BACKGROUND OF SECTION 14(E)

In 1968, Congress added section 14(e) to the Exchange Act as part of a group of legislative amendments popularly referred to as the Williams Act.13 The enactments occurred at a time when tender

10. See infra text accompanying notes 95-110 (discussion of cases debating rule's validity).
11. 17 C.F.R. § 240.10b-5 (1988). Rule 10b-5 provides as follows:
   It shall be unlawful for any person, directly or indirectly, by the use of any
   means or instrumentality of interstate commerce, or of the mails or of any
   facility of any national securities exchange, (a) To employ any device, scheme,
   or artifice to defraud, (b) To make any untrue statement of a material fact or
   to omit to state a material fact necessary in order to make the statements
   made, in the light of the circumstances under which they were made, not mis-
   leading, or (c) To engage in any act, practice, or course of business which oper-
   ates or would operate as a fraud or deceit upon any person, in connection with
   the purchase or sale of any security.
12. 15 U.S.C. § 78j(b) (1988). Section 10(b) of the Exchange Act provides, in
   pertinent part, as follows:
   (a) 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 secur-
   ity registered on a national securities exchange or any security not so regis-
   tered, 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.

Id.
13. The Williams Act added sections 13(d), 13(e), 14(d), 14(e) and 14(f) to the
   Section 13(d) requires those acquiring a certain threshold percentage of a com-
   pany's stock to file reports disclosing such information as the purchaser's back-
   ground and identity, the source of the funds to be used in making the
   purchase, the purpose of the purchase, and the extent of the purchaser's hold-
   ings in the target company. 15 U.S.C. § 78m(d) (1982). Section 13(e) imposes
   restrictions on certain repurchases of stock by corporate issuers. 15 U.S.C. §
   78m(e) (1982). Section 14(d) imposes specific disclosure requirements on those
   making a tender offer. 15 U.S.C. § 78n(d)(1) (1982). Section 14(d) also imposes
   specific substantive requirements on those making a tender offer. These re-
   quirements include allowing shareholders to withdraw tendered shares at cer-
   tain times during the bidding process, 15 U.S.C. § 78n(d)(5) (1982), the prora-
   tion of share purchases when the number of shares tendered exceeds the
offers were virtually unregulated and emerging as the preferred means for corporate takeovers. In *Piper v. Chris-Craft Industries, Inc.*, the United States Supreme Court undertook an extensive review of the legislative history of the Williams Act. It concluded that "the sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer." On another occasion, the Supreme Court indicated that the Williams Act's purpose was "to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required to respond without adequate information . . . ." The 1967 Senate and 1968 House proceedings enacting the Williams Act confirm that the primary, if not sole, objective of Congress was to protect target company shareholders by imposing disclosure requirements upon bidders.

Several commentators have observed that the Williams Act's purpose is relatively narrow in scope. For example, noticeably absent from the legislative scheme of the Williams Act is a desire to impose duties upon persons other than bidders and those opposing a tender offer. The SEC, on the other hand, views the legislative purpose of the Williams Act more broadly. It has described the statutory focus as extending well beyond a bidder's duty of disclosure to

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number of shares sought, 15 U.S.C. § 78n(d)(6) (1982), and the payment of the same price to all those whose shares are purchased, 15 U.S.C. § 78n(d)(7) (1982). Section 14(f) imposes disclosure requirements when new corporate directors are chosen as the result of a tender offer. 15 U.S.C. § 78n(f) (1982).

472 U.S. 1, 9 n.9 (1985).


16. Id. at 35.


19. WASH. & LEE Note, supra note 14, at 1062-63; GEO. WASH. Note, supra note 14, at 544. See also Poser, *Misuse of Confidential Information Concerning a Tender Offer as a Securities Fraud*, 49 BROOKLYN L. REV. 1265, 1285 (1983). The arguably narrow reach of the Williams Act raises questions concerning the enforceable scope of § 14(e) and Rule 14e-3 and the ability of these provisions to impose duties upon non-corporate insiders and non-fiduciaries. See infra text accompanying notes 74-94 (discussion of courts' imposition of duties).
target shareholders.\(^{20}\)

Section 14(e) of the Exchange Act makes it unlawful for any person to make material misstatements or omissions, or to engage in fraudulent, deceptive, or manipulative acts or practices in connection with a tender offer.\(^{21}\) It has been characterized by the Supreme Court as a “broad anti-fraud prohibition”\(^{22}\) which is “modeled on the antifraud provisions of §10(b) of the [Exchange] Act and Rule 10b-5.”\(^{23}\) The Supreme Court has commented that the legislative history of section 14(e) is “sparse.”\(^{24}\) None-the-less, the Court has explained that section 14(e) “supplements the more precise disclosure provisions found elsewhere in the Williams Act, while requiring disclosure more explicitly addressed to the tender offer context than that required by §10(b)”; and, “[n]owhere in the legislative history is there the slightest suggestion that §14(e) serves any purpose other than disclosure.”\(^{25}\)

**II. Rulemaking Authority under the 1970 Amendment**

In 1970, Congress amended Section 14(e) by adding a provision that vests the SEC with rulemaking authority over fraudulent, deceptive, or manipulative acts and practices in connection with tender offers.\(^{26}\) The Supreme Court in *Schreiber v. Burlington Northern, Inc.*,\(^{27}\) described the 1970 amendment as providing “a

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20. See Adoption of Rule 14e-3, Exchange Act Release No. 34-17120, 45 Fed. Reg. 60410 reprinted in (1980 Transfer Binder) Fed. Sec. L. Rep. (CCH) ¶ 82,646, at 83,453-64 (September 4, 1980) [hereinafter Release No. 34-17120]. The SEC has stated that trading abuses by persons in possession of material, nonpublic information pertaining to tender offers “was a matter of concern to Congress when it enacted the Williams Act” and that “market disruption” and “unfair disparities in market information” are proper concerns of the legislation. *Id.* ¶ 82,646, at 83,456-57.


23. Schrieber, 472 U.S. at 10. It is important to note that the language of § 14(e) and § 10(b), which prohibits “any manipulative or deceptive device or contrivance” in connection with the purchase or sale of a security, are substantively equivalent. For the text of these sections, see supra notes 6 and 12. Section 14(e) differs from § 10(b) in that § 14(e) adds a prohibition against material misstatements or omissions. However, Rule 10b-5, promulgated under § 10(b), contains an identical prohibition. For the text of rule 10b-5, see supra note 11. Also, § 14(e) differs substantially from § 10(b) and Rule 10b-5 in that the former applies solely to tender offers, whereas the later provisions apply to purchases and sales of securities. See Applied Digital Data Systems, Inc. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1153 n.21 (S.D.N.Y. 1977). The symmetry between the two statutory sections has prompted certain courts to construe them *in pari materia* and give similar interpretations to the language of each section. See infra text accompanying notes 67-73 *(in pari materia* construction of sections 10(b) and 14(e)).


25. Id. at 10-11.


mechanism for defining and guarding against those acts and practices which involve material misrepresentation or nondisclosure" and giving the SEC "latitude to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts." 28

It has been suggested that the intended scope of rulemaking authority delegated the SEC under the 1970 Amendment is limited to regulation of bidders and target companies. 29 As an adjunct, it is argued that the regulation of non-fiduciaries and non-corporate insiders is outside of the intended scope of section 14(e). 30 Indeed, the Schreiber court, in describing the essence of section 14(e), seemingly confined its applicability to those "persons engaged in making or opposing tender offers or otherwise seeking to influence the decision of investors or the outcome of the tender offer." 31

Other authorities, including the SEC, view the 1970 rulemaking grant as permitting the imposition of duties on all persons, regardless of their insider or outsider status, who trade in target company securities. 32 During the Senate hearings on the 1970 amendments, Senator Williams asked the SEC Chairman to furnish examples of practices the SEC would prohibit. The SEC Chairman responded that the agency's rules, among other things, would prohibit a person aware of a pending tender offer from trading in target company securities without first making public disclosures about the tender offer. 33 Because the illustration given by the SEC Chairman envisaged mere awareness of a pending tender offer (irrespective of duties owed to any persons) as sufficient for a rule violation, proponents point to this event as indicating broad rulemaking intent.

III. Rulemaking Authority Under Section 23(a)

Rule 14e-3 was also promulgated by the SEC pursuant to its general rulemaking authority under section 23(a)(1) of the Exchange

28. Schreiber, 472 U.S. at 12 n.11.
32. See United States v. Chestman, 704 F. Supp. 451, 457 (S.D.N.Y. 1989), rev'd, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491) (citing O'Connor & Associates v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179 (S.D.N.Y. 1981)). The court in Chestman stated the "statutory language [granting rulemaking authority to the SEC] is open-ended as to the transactions which might be covered . . . ." Id. See also Release No. 34-17120, supra note 20, ¶ 82,646, at 83,453 ("The rule pertains to trading by persons in securities which may be the subject of a tender offer as well as tipping of material nonpublic information relating to a contemplated tender offer").
This section has been broadly construed to authorize the SEC to adopt rules that are "reasonably related to the purposes of the enabling legislation." Under this test, the SEC has successfully defended the validity of another rule promulgated pursuant to the general authority of section 23(a)(1).

Presumably, the SEC cannot rely upon the general rulemaking grant of section 23(a)(1) in promulgating a rule that is beyond the purview of an explicit rulemaking grant carefully crafted by Congress to implement a specific section of the Exchange Act. Accordingly, an analysis of the validity of Rule 14e-3 must focus most heavily on the precise rulemaking authority under section 14(e) and not the broad authority found under section 23(a)(1).

IV. ADOPTION OF RULE 14E-3

In adopting Rule 14e-3 on September 4, 1980, the SEC established a new "disclose or abstain from trading" regulation specifically tailored to tender offers. In essence, the rule bars any person who possesses material information relating to a tender offer from trading in the securities of the target company if: (a) the bidder has commenced or taken a substantial step towards commencing a bid; (b) such person knows or has reason to know that the information he possesses was acquired from the bidder or the target company; and, (c) such person knows or has reason to know that the information is nonpublic. The rule broadly applies to "any person who

35. Touche Ross & Co. v. SEC, 609 F.2d 570, 579 (2d Cir. 1979), (quoting Mourning v. Family Publications Services, Inc. 411 U.S. 356, 369 (1973)).
36. Touche Ross, 609 F.2d at 582. The Touche Ross court upheld the validity of Rule 2(e) of the SEC's Rules of Practice. See also 17 C.F.R. § 201.2(e) (1988). Rule 2(e) was adopted solely pursuant to the rulemaking authority of § 23(a)(1). This rule has been the basis for disciplinary proceedings against professionals practicing before the SEC. It is noteworthy that the court, while observing that the "[r]ule and its predecessors [had] been in effect for over forty years", stated "the mere fact that the [r]ule is of long standing does not relieve us of our responsibility to determine its validity." Touche Ross, 609 F.2d at 578.
37. See D. LANGEVOORT, INSIDER TRADING REGULATION, § 7.05, at 193 (Clark Boardman, 1989 Ed.) [hereinafter LANGEVOORT].
39. 17 C.F.R. § 240.14e-3(a) (1988). See Release No. 34-17120, supra note 20, ¶ 82,646, at 83458-59. Exempted from the "disclose or abstain from trading" rule are multiservice financial institutions that routinely possess material, nonpublic information yet maintain an effective "Chinese Wall" to insulate the persons making investment recommendations or decisions from exposure to nonpublic information. To avail itself of the exemption, the institution must demonstrate that the persons making investment recommendations or decisions had no actual knowledge of the inside information and that the institution had implemented procedures reasonably designed
falls within its boundaries, even in the absence of a relationship of trust and confidence, or any fiduciary duty."

Rule 14e-3 also imposes a broad prohibition on "tipping." The bidder and the target company, including their respective officers, directors, employees, agents and advisors, are proscribed from divulging material, nonpublic information about the tender offer when it is reasonably foreseeable that the communication is likely to result in a violation of the rule. This "anti-tipping" provision also applies to "tippees" of any of the foregoing persons, even if they are unrelated to the bidder or the target company.

V. DEFINING THE SCOPE OF SEC AUTHORITY

As previously mentioned, Rule 14e-3 seeks to govern the conduct of all persons in possession of nonpublic tender offer information who trade in target company securities. The rule imposes a duty to disclose or abstain from trading upon fiduciaries and non-fiduciaries alike. Certain critics suggest that in promulgating the rule, the SEC set its protective aspirations too high. By seeking to regulate a class of persons that is broader than the class of persons to prevent insider trading abuses. 17 C.F.R. § 240.14e-3(b) (1988) (Rule 14e-3(b)). See Release No. 34-17120, supra note 20, ¶ 82,646, at 83,460-63. Also exempt from Rule 14e-3 are sales by investors to the bidder or its agents. 17 C.F.R. § 240.14e-3(c) (1988). See also Release No. 34-17120, supra note 20, ¶ 82,646, at 83,462-63.


42. 17 C.F.R. § 240.14e-3(d) (1988). See also Release No. 34-17120, supra note 20, ¶ 82,646, at 83,463-64. Rule 14e-3(d) exempts communications made among the bidder, the target company, and their agents and advisers, in good faith, relating to the conduct of, or in opposition to, a tender offer. 17 C.F.R. § 240.14e-3(d) (1988). The SEC stated that although the rule "is not intended to have an impact on casual and innocently motivated social discourse" it applies "where the circumstances... make it reasonably foreseeable that a violation of Rule 14e-3 is likely to occur." Id.

43. Id. The broad reach of the "anti-tipping" rule and the absence of a need to show that the tipper enjoyed "personal benefit" as a result of the tipping activity is a matter of significant concern to several commentators. See infra text accompanying notes 146-158 (discussion of anti-tipping provision of the rule).

44. See supra text accompanying note 39 (discussion of when a person is barred from trading). The rule technically covers trading in the security sought by the bidder in its tender offer, but it also includes any other security convertible into or exchangeable for such target company security or any option or right to obtain or to dispose of such security. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,458.

45. Fiduciary status is, therefore, irrelevant to the duty to disclose or abstain created under Rule 14e-3. Insiders and outsiders are treated identically. Thus, an outsider who trades after he overhears a conversation concerning a tender offer would violate the rule, even though he had no direct contact or relationship with the insider. Langevoort, supra note 37, § 7.02, at 184-5.
intended to be protected under the enabling statute, they contend that the SEC exceeded its rulemaking authority. These authorities observe that the Williams Act legislators were quite narrowly concerned with regulating the conduct of bidders and target companies. Thus, persons unrelated to either of the foregoing were never intended to fall within the rubric of section 14(e) or any rules promulgated thereunder. To buttress their view, critics of the rule cite the seminal case of *Ernst & Ernst v. Hochfeller*, where the Supreme Court concluded, *inter alia*, that an implementing rule cannot be broader in scope than the statutory section it implements.

The SEC would no doubt disagree with the notion that the Williams Act was intended to bestow a narrow scope of rulemaking authority. For example, in its adopting release for Rule 14e-3, the SEC articulated the ills the rule was intended to cure. It stated that trading by persons in possession of material, nonpublic information relating to a tender offer creates unfair disparities in market information, denies shareholders the ability to make informed investment decisions, and disrupts the orderly functioning of the securities markets. Such a statement is hardly consistent with the view that the Williams Act's protective scope extends only to the conduct of bidders and target companies, and not to the trading practices of others.

Support for a more expansive interpretation of the Williams

46. See, e.g., Gruenbaum, “Acquisitions and Mergers — The New Disclosure or Abstain From Trading Rule: Has the SEC Gone Too Far?” 4 CORP. L. REV. 350 (1981). The author states:

By its adoption of the disclose or abstain from trading rule, the Commission has created what otherwise would appear to be a nonexistent duty in the context of tender offers. The Williams Act imposes a disclosure duty only upon a limited class of persons (i.e., persons who acquire more than 5 percent of an issuer's registered securities and persons who make tender offers for, or request or invite tenders of, securities). The express language of the [Exchange] Act does not go beyond these narrow parameters in creating an affirmative duty of disclosure, and any extension of the language in accordance with the legislative intent of the [Exchange] Act probably should go no further than to include persons involved in or parties to the tender offer.


47. See *supra* notes 18-19 and accompanying text (discussion of Williams Act's purpose).

48. See *supra* note 46.


50. *Id.* at 214. In *Ernst*, the Court concluded that, notwithstanding the language of Rule 10b-5, which arguably could be interpreted to impose a lower culpability standard, the statutory language of section 10(b) was controlling and required scienter as an element of a fraud violation. *Id.*

Act's purpose can be found in *O'Connor & Associates v. Dean Witter Reynolds, Inc.* In that decision, the District Court for the Southern District of New York rejected "the proposition that the Williams Act was intended merely to regulate transactions between the tender offeror and the shareholder of the target company, not to regulate transactions on the open market in which the shareholder of the target company may engage." The *O'Connor* court found the language of section 14(e) to be "open-ended as to the transactions which might be covered" and, accordingly, upheld the validity of Rule 14e-3.

The precise language of the 1970 Amendment to section 14(e) also supports a broader interpretation of SEC rulemaking authority under the Williams Act. In that amendment, Congress broadly authorized the SEC to "define . . . such acts and practices as are fraudulent, deceptive or manipulative" and to "prescribe means reasonably designed to prevent" such practices. The express authorization to define fraud and prescribe means to prevent it contemplates a broad array of rulemaking possibilities. Moreover, the SEC's interpretation of the scope of its rulemaking authority should be given judicial deference.

Proponents of Rule 14e-3's validity contend that the rule has received Congressional ratification on two recent occasions. In

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53. *Id.* at 1191.
54. *Id.* at 1191 and 1193.
55. 15 U.S.C. § 78n(e) (1988). See also supra note 6 (text of § 14(e)).
56. *See O'Connor*, 529 F. Supp. at 1191. In *O'Connor*, the court stated: "[T]he broad grant of authority to the SEC to define the particular practices banned by the statute supports the proposition that the statute was not intended to be limited . . . ." *Id.*
57. See supra note 6 (text of §14(e)).
58. The standard of review for a court considering the validity of an administrative agency's rule was stated in United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491, at 8) (quoting Batterton v. Francis, 432 U.S. 416 (1977) ("Rules and Regulations adopted by an administrative agency pursuant to authority expressly conferred upon the agency by Congress are said to have 'legislative effect' and are therefore 'entitled to more than mere deference or weight.' ")) and United States v. Marcus Schloss & Co., 710 F. Supp. 944, 956 (S.D.N.Y. 1989). Those courts, citing Batterton, 432 U.S. at 425-26, each explained that a reviewing court cannot freely set aside a rule adopted by an agency merely because the court would have interpreted the statute differently. Instead, the rule can be set aside only if the agency exceeded its statutory authority or the agency's promulgation of the rule was arbitrary, capricious, or an abuse of discretion. Chestman, 704 F. Supp. at 454; Marcus Schloss, 710 F. Supp. at 956.
59. See, e.g., Brief for the United States at 47-49, United States v. Chestman, F.2d (2d Cir. 1989), (No. 89-1276) [hereinafter Chestman Appellate Brief]. See also United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491, at 9) (Miner, J.). But see id. at 11-12 (Mahoney, J., "I am not persuaded by the government's contention that subsequent statutory enactments evidence Congressional adoption of the commissioner's view of rule 14e-3."). D. Langevoort, supra note 37, § 7.05, at 197-98.
1984, Congress passed the Insider Trading Sanctions Act of 1984 ("ITSA"), the primary purpose of which was to furnish the SEC with authority to seek treble penalties in civil actions from persons who trade while in possession of material, nonpublic information. Before enacting ITSA, Congress was specifically aware that a violation of Rule 14e-3 would trigger the proposed legislation's penalty provision. Similarly, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), which gave legislative recognition to a private, civil cause of action for damages against insider traders. Again, Congress was cognizant that Rule 14e-3 could provide the basis for a private action under the new statute. By failing to expressly disavow the rule's validity, Congress implicitly embraced the rule as a valid exercise of the SEC's rulemaking authority.

VI. In Pari Materia Construction of Sections 10(b) and 14(e)

Before considering various arguments which rely less on strict legislative intent and more on court interpretations of the requisite elements of insider trading liability, it is important to note a significant and recurring premise postulated by the rule's critics. That premise, simply stated, is: because the courts have tended to construe the language of section 10(b) and section 14(e) of the Exchange Act in pari materia, the fraud elements imposed by the courts under these two sections, including their implementing rules (i.e., Rule 10b-5 and Rule 14e-3), should be identical. The often
Validity To SEC Rule 14e-3

cited authority for this proposition is found in the Schreiber decision which stated that section 14(e) was “modeled” on section 10(b) and Rule 10b-5.68 Indeed, the operative words of the two antifraud provisions are substantially parallel. This has prompted a number of courts to impose duties and standards under section 10(b) and section 14(e) that are identical.69

Other courts and authorities dispute the notion that the two antifraud provisions have an identical reach.70 Proponents of this position observe that it is doubtful Congress would have passed “a superfluous and wholly repetitive statutory provision.”71 Drawing from the Schreiber court’s analysis, they note that section 14(e) “supplements the more precise disclosure provisions found elsewhere in the Williams Act, while requiring disclosure more explicitly addressed to the tender offer context than that required by § 10(b).”72 The SEC, in adopting Rule 14e-3, made it clear that it regarded the new rule


68. Schreiber v. Burlington N., Inc., 472 U.S. 1 (1985). In Schreiber, the Court said “[b]ecause of the textual similarities, it is often assumed that § 14(e) was modeled on § 10(b) and Rule 10b-5.” Id. at 10 n.10. See also Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 24 (1977); Panter, 646 F. 2d at 283; Vaughn v. Teledyne, Inc., 628 F. 2d 1214, 1219 (9th Cir. 1980); Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 362 (2nd Cir.), cert. denied, 414 U.S. 910 (1973). But see United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491 at 9). But see id. at 11, 13 (Mahoney & Carman, J.J.); United States v. Marcus Schloss & Co., Inc., 710 F. Supp. 944, 957 (S.D.N.Y. 1989) (“Congress delegated a different and greater level of authority to the SEC pursuant to § 14(e) than it had pursuant to § 10(b).”).

69. See, e.g., Crane v. American Standard, Inc., 603 F.2d 244, 249 (2d Cir. 1979) (language of § 14(e) and Rule 10b-5 are nearly identical); Herbst v. ITT Corp., 495 F. 2d 1308, 1313 n.11 (2d Cir. 1974) (principles embodied in Rule 10b-5 and § 10(e) are identical); Smallwood v. Pearl Brewing Co., 489 F.2d 579, 605 (5th Cir. 1974). In Smallwood, the court held that Congress intended § 14(e) to create duties identical to those imposed under Rule 10b-5. Smallwood, 489 F.2d at 605. The court also found that when Congress drafted § 14(e) with language similar to Rule 10b-5, Congress intended the law concerning Rule 10b-5 to apply to § 14(e). Id. In Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973), the court observed that § 14(e) codified the existing law under § 10(b). Id. at 361. See also WASH. & LEE Note, supra note 14, at 1061. Id.


71. Chestman, 704 F. Supp. at 458. See also Release No. 34-17120, supra note 20, ¶ 82,646, at 83,455-56. In that release, the SEC rebutted several commentators’ suggestions that the rule might be superfluous by citing the duty requirement imposed under Chiarella for § 10(b), but not imposed under § 14(e). Id. Accordingly, had Chiarella not imposed the duty requirement and, instead, found liability on the basis of “mere possession” of material, nonpublic information, the rule might be viewed as superfluous. See WASH. & LEE Note, supra note 14, at 1059.

as separate and distinct from Rule 10b-5, stating that "no inference should be drawn [from the adoption of Rule 14e-3] respecting the applicability of Section 10(b) and Rule 10b-5" to various genre of insider trading abuses involving tender offers.73

VII. THE CHIARELLA DUTY REQUIREMENT

One explicit and controversial initiative by the SEC in adopting Rule 14e-3 was to close a legal "gap"74 created as a result of the United States Supreme Court's decision in Chiarella v. United States.75 In that decision, the Court held that a duty to disclose material, nonpublic information (or abstain from trading) under section 10(b) is not owed to all market participants, but instead is owed only to persons with whom one has a fiduciary or other relationship of trust and confidence.76 The Court in Chiarella specifically disclaimed that such a duty arises from the "mere possession of nonpublic information."77 Although the Court was unable to locate any definitive legislative history to guide it in its interpretation of the intended scope of section 10(b), it found such guidance in common law principles of fraud.78 Those precepts mandated that a breach of fiduciary duty be established as a precondition for liability.79 Thus, in Chiarella the Court reasoned that the SEC could not proscribe conduct under a broad reading of Rule 10b-5 which exceeded the statutory limits of section 10(b).80

73. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,456 n.20. In particular, the SEC expressed its ongoing concern over Rule 10b-5 violations stemming from misappropriation of nonpublic information — an area left open by the Chiarella court. Id. at 83,456. The SEC also stated that "the adoption of Rule 14e-3 should not be construed as relating in any way to the [SEC's] authority to regulate the conduct of a bidder under section 10(b) or section 14(e) of the Exchange Act." Id. at 83,454 n.2.

74. The SEC elaborated at length in the adopting release for Rule 14e-3 about the potential impact of the Chiarella decision upon the rule's validity. See Id. at 83455.

75. 445 U.S. 222 (1980). Vincent Chiarella was an employee of a financial printer who, through his position, discerned the identities of four tender offer targets and one merger candidate. Id. at 235. He thereafter purchased the securities of the target companies without disclosing his knowledge of the impending takeovers. Id. Following the public announcements of the takeover attempts, Chiarella sold the securities in the open market at a $30,000 profit. Id. After an SEC investigation of Chiarella's trading activity, he entered into a consent decree requiring him to disgorge his profits. Id. In a subsequent criminal prosecution, Chiarella was convicted on 17 counts of violating § 10(b) and Rule 10b-5. Id. On appeal, the Supreme Court concluded that, since Chiarella was not in a fiduciary or other relationship of trust and confidence with the open market purchasers, no violation of § 10(b) or Rule 10b-5 had occurred and reversed the conviction. Id.

76. Id. at 232-33.

77. Id.

78. Id. at 230.

79. Id. at 235.

80. Id. at 233-34. See also Aaron v. SEC, 446 U.S. 680, 691 (1980); Ernst &
Critics of Rule 14e-3 argue that in Chiarella, the Court undertook to define insider trading fraud generally and not merely in the specific context of section 10(b) violations. In addition, they argue that the SEC, in adopting Rule 14e-3, was attempting to establish parameters for insider trading violations under a statutory antifraud provision which parallels section 10(b). As a result, the rule should be subject to the same limitations imposed by the Court in Chiarella. They contend that the SEC should not be permitted to repudiate Chiarella by resurrecting "mere possession" as the basis for insider trading liability concerning tender offers.


82. See supra text accompanying notes 67-73 (discussion of in pari materia construction of sections 10(b) and 14(e)). In one sense, § 14(e) and Rule 14e-3 might be functionally viewed as a subset of § 10(b) and Rule 10b-5. The scope of the former antifraud provision (involving tender offers) would, in a number of cases, be subsumed within the scope of the latter antifraud provision (involving purchases and sales of securities). For example, a successful tender offer would culminate in a "purchase" by the bidder and a "sale" by the target shareholder. Support for this view can be found in Chiarella dicta wherein the court referred to § 10(b) as "a catchall clause [designed] to prevent fraudulent practices." Chiarella, 445 U.S. at 226.

83. See supra note 81 (commentators arguing that Chiarella defined insider trading fraud generally).

84. See, e.g., ABA Task Force Report, supra note 81, at 250-51. It is noteworthy that the "trading while in possession" requirement of the rule arguably makes the trading person's motivation irrelevant. This view is consistent with the SEC's interpretation of insider trading liability under § 10(b). See Langevoort, supra note 37, § 7.02, at 184 n.9. The SEC's "trading while in possession" formulation focuses on the result of the trade (i.e. depriving an investor the opportunity to make an informed investment decision) and not the trader's intent. According to the SEC, this avoids difficult questions of proof regarding the mental state of the trading person. Chestman Appellate Brief, supra note 59, at 54. It is debatable whether this aspect of the rule none-the-less provides a separate basis for challenging the rule's validity. The argument, also relying on an in pari materia construction of § 10(b) and § 14(e), would rest on the premise that courts have tended to require that the violative trade be made on the basis of the material, nonpublic information. See, e.g., Dirks v. SEC, 463 U.S. 646, 653 n.10 (1983); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 839 (2d Cir. 1968). This argument was raised by the defendant, but dismissed by the court, in Chestman. United States v. Chestman, 704 F. Supp. 441, 458 n.8 (S.D.N.Y. 1989), rev'd, No. 89-1276 (2d Cir. May 2, 1990)(1990 WL 57491). As noted by the Chestman court, the possession/use matter is interrelated with the requisite culpability standard under Rule 14e-3, which requires that the violator "know or have reason to know" that the nonpublic information in his possession was derived from an inside source. United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491, at 9) ("... it would weaken the potency of this grant of authority to require actual proof of reliance. Trading, with the requisite knowledge is sufficient."). See infra text accompanying notes 111-120 (discussion of the applicable state of mind).
The SEC's response to these duty-based arguments is that *Chiarella* should not be viewed as binding upon the SEC's rulemaking authority under Section 14(e). In its adopting release, the SEC characterized *Chiarella* as a "limited holding" and intimated that the *Chiarella* findings would be unresponsive to the regulatory concerns of the Williams Act. The duty requirement imposed under section 10(b) was based on common law fraud principles, and the Court in *Chiarella* was constrained to adhere to those principles in the absence of legislative guidance. In contrast, argues the SEC, at least a modicum of legislative guidance can be found under section 14(e).

Further, the SEC asserts that an important legislative objective of the Williams Act was to counteract "market disruption" and "unfair disparities in market information" which results from insider trading activity involving tender offers. This objective cannot be accomplished by regulating a class of persons narrowly confined to fiduciaries and others in a position of trust and confidence. The SEC's view in this regard is consistent with the adoption of an "equal access" or "parity of information" rule designed to protect the efficient functioning of the market as a whole.

85. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,456. In that release, the SEC said, "Moreover, the [Chiarella] decision did not suggest any limitation on the [SEC's] authority under Section 14(e) to adopt a rule regulating trading while in possession of material, nonpublic information relating to a tender offer." Id.

86. Id. at 83,456 n.20.

87. Id. at 83,456-57.

88. See Langevoort, supra note 37, ¶ 7.05, at 195.

89. See supra note 33 and accompanying text (remarks of Senator Williams and SEC Chairman Budge).

90. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,457. See supra text accompanying note 15 (Supreme Court's review of the legislative history of the Williams Act).

91. One author has described the SEC's position in this regard as based on an "egalitarian theory with respect to use of material information about the target company." Heller, supra note 46, at 544-45.

92. See ABA Task Force Report, supra note 81, at 250. In the adopting release for Rule 14e-3, the SEC asserted that no distinction should be drawn between corporate and market information, because both may be material to an investment decision. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,455 n.12. Such a position underlies an "equal access" rule among market participants. Id.


94. See Heller, supra note 46, at 545. See also Justice Powell's remarks in *Chiarella*: "[N]either the Congress nor the [SEC] has ever adopted a parity-of-information rule." *Chiarella* v. United States, 445 U.S. 222, 233 (1980). As an example of "when [advance] use of market information may not harm operation of the securities market," Justice Powell pointed to section 13(d)(1) under the Williams Act, 15 U.S.C. § 78m(d)(1) (1988), which permits a bidder to purchase up to 5% of the target company's stock prior to public disclosure of the tender offer plan. Id. at n.15. Interestingly, Justice Powell cited in slight contrast the practice of "warehousing" which "takes place when a corporation gives advance notice of its intention to launch a tender offer to institutional investors who then are able to purchase stock in the target company before the tender offer is made public and the price of shares rises." Id.
The criminal defendants in two recent cases, United States v. Chestman, and United States v. Marcus Schloss & Co., Inc., strenuously argued that Rule 14e-3 is invalid since it imposes liability in the absence of a pre-existing fiduciary duty. In both cases, the defendants cited Chiarella and Dirks v. SEC in support of

On appeal, the Second Circuit Court of Appeals reversed the convictions on all counts except the rule 14e-3 convictions. Id. at 9. The three appellate judges concurred on the reversal of all counts except the rule 14e-3 convictions. Id. at 9, 12, 13. Judge Miner supported the convictions under rule 14e-3 by finding that rule 14e-3 does not have a breach of fiduciary duty requirement. Id. at 8, 9. Judge Carman urged a reversal of the rule 14e-3 counts and found that the Chiarella duty requirement should be read into the rule. Id. at 12, 13. Judge Mahoney also urged a reversal of the 14e-3 convictions, and found that the rule should be invalidated because of the lack of the duty. Id. at 10-11.

96. 710 F. Supp. 944 (S.D.N.Y. 1989). The Marcus Schloss & Co. case involved a criminal prosecution in which the indictment alleged a “wheel” insider trading conspiracy and several related substantive counts. Id. at 951. The conspiracy charge alleged that an associate, who the court refers to as “Mr. David,” at the law firm of Paul, Weiss, Rifkind, Wharton & Garrison, misappropriated material, nonpublic information in respect to five target companies. Id. at 948. On four of the five stocks, David tipped inside information to Andrew Solomon, a Marcus Schloss & Co. employee, who passed the information on to D. Ronald Yagoda, who in turn caused Marcus Schloss & Co. to trade in the target company securities. Id. With respect to the fifth stock, the flow of information went from Yagoda through Solomon to David. Id. The government alleged § 10(b) and Rule 10b-5 violations with respect to all five stocks. Id. at 955. Two of the stocks involved tender offers and, consequently, as to those stocks, additional violations of § 14(e) and Rule 14e-3 were alleged. Id.


99. 463 U.S. 646 (1983). Dirks, like Chiarella, stands generally for the proposition that there can be no violation of Rule 10b-5 absent a duty to disclose nonpublic information arising from a fiduciary or other relationship of trust and confidence. See id. at 657. Dirks is also a seminal case in the area of “tipping” liability. See infra text accompanying notes 146-158 (discussion of “tipping” liability).
their positions. They asserted that those seminal Rule 10b-5 holdings, when coupled with the Schreiber court's recognition of a "virtual identity"\textsuperscript{100} between section 10(b) and section 14(e), mandated a finding that the SEC's rulemaking effort under section 14(e) was excessive.\textsuperscript{101}

In Chestman, the district court relied primarily on the O'Connor decision\textsuperscript{102} in rejecting the defendant's proposition that section 10(b) and section 14(e) were intended to have an identical reach.\textsuperscript{103} After an extensive review of section 14(e)'s legislative history, the trial court found such a proposition to be contrary to congressional intent.\textsuperscript{104} The Chestman court also rejected the notion that the Schreiber decision in any way limited the SEC's rulemaking authority under section 14(e).\textsuperscript{105} Accordingly, it determined that Rule 14e-3 represented a valid exercise of the SEC's authority.\textsuperscript{106}

On appeal, the Second Circuit reversed the trial court's judgment of conviction.\textsuperscript{107} The appellate panel unanimously concurred in the reversal of Chestman's convictions on all counts except for the rule 14e-3 counts.\textsuperscript{108} Judge Miner, writing the opinion of the court, distinguished the SEC's rulemaking authority under sections 10(b) and 14(e) and concluded that the rule did not require a fiduciary duty.\textsuperscript{109} In his partial disent, however, Judge Carman applied an \textit{in pari materia} construction to sections 10(b) and 14(e) and found that a breach of a fiduciary duty was essential to a rule 14e-3 violation.\textsuperscript{110} Judge Mahoney, also dissenting on the rule 14e-3 counts, would have invalidated rule 14e-3 because the SEC failed to expressly include a fiduciary duty requirement within the rule.\textsuperscript{111}

In Marcus Schloss & Co., the court again relied heavily on the O'Connor legislative analysis in dismissing the defendant's attack

\begin{thebibliography}{100}
\bibitem{100} Chestman, 704 F. Supp. at 458. The Marcus Schloss & Co. decision acknowledges defendant's assertion that § 14(e) was "modeled" on § 10(b). Marcus Schloss & Co., 710 F. Supp. at 957.
\bibitem{101} Chestman, 704 F. Supp. at 454; Marcus Schloss & Co., 710 F. Supp. at 956-57.
\bibitem{103} Chestman, 704 F. Supp. at 458.
\bibitem{104} Id. at 454-58.
\bibitem{105} Id. at 458. The court commented that defendant's assertion that § 10(b) and § 14(e) are identical "presents an obscured picture of the Supreme Court's analysis [in Schreiber]." Id.
\bibitem{106} Id.
\bibitem{107} United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491, at 9).
\bibitem{108} Id. at 9-13.
\bibitem{109} Id. at 8-9.
\bibitem{110} Id. at 12-13.
\bibitem{111} Id. at 10-11.
\end{thebibliography}
upon the rule’s validity.112 Citing the Chestman District Court opinion with approval, it similarly refused to find Chiarella and Dirks to be controlling in defining the scope of section 14(e).113 The court characterized the SEC’s rulemaking powers under section 14(e) as including “judicially recognized, broad and open-ended regulatory latitude.”114 In validating the SEC’s adoption of Rule 14e-3, the court stated:

The absence of a fiduciary duty may make insider trading less fraudulent or deceptive; but the Schreiber Court recognized the SEC’s statutorily derived power to regulate even “nondeceptive activities” if the regulations prescribed “means reasonably designed to prevent” fraudulent, deceptive, or manipulative acts and practices. A rule requiring disclosure of material, nonpublic information before trading in the market cannot be said to fall outside that authority.115

IX. APPLICABLE STATE OF MIND: SCIENTER V. NEGLIGENCE

Rule 14e-3 is violated if the trading person “knows or has reason to know” the information in his possession is nonpublic and has been acquired directly or indirectly from an inside source.116 Commentators observe that the “reason to know” language contemplates a duty of inquiry with respect to the information and its source.117 Thus, a recipient of tender offer information who acts or fails to act in derogation of that duty is negligent.118 This quasi-negligence standard, it is argued, is directly contrary to the Supreme Court’s deci-

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113. Id.
114. Id.
115. Id.
116. 17 C.F.R. § 240.14e-3(a). For the text of rule 14e-3, see supra note 5. See also Release No. 34-17120, supra note 20, ¶ 82,646, at 83,458. In the adopting release, the SEC explained that the “know or has reason to know” standard applied only to the requirements that the information be nonpublic and acquired from an inside source. The standard does not apply to the requirements that the information be material or related to a tender offer. Id.
117. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,458. The intent standard was evidently designed to protect innocent persons who simply hear rumors circulating in the marketplace without any specific knowledge as to their source. See D. Langevoort, supra note 37, ¶ 7.01, at 187; Heller, supra note 46, at 544. The SEC has suggested that the standard does have an attendant duty of inquiry. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,458 n.36. However, at least one author disagrees that a general duty of inquiry can be imposed under this standard; instead, that author argues that the duty would only arise “where one or more ‘red flags’ place the recipient of the information on notice that there is a substantial possibility that the information has been leaked or tipped.” D. Langevoort, supra note 37, ¶ 7.01, at 188.
118. Peloso and Krause, supra note 81, at 948; Wang, supra note 81, at 308. See also D. Langevoort, supra note 37, ¶ 7.01, at 188; ABA Task Force Report, supra note 81, at 250; Heller, supra note 46, at 546.
sion in *Ernst & Ernst v. Hochfelder.* Critics argue that a negligence standard under the rule results in a more intrusive level of insider trading regulation than presently condoned by the courts. The argument that this distinction provides the basis for invalidating Rule 14e-3 rests, of course, on an *in pari materia* construction of section 10(b) and 14(e).

The courts are not uniform in their interpretation of the appropriate mental state under section 14(e). None of the courts which have specifically considered the validity of Rule 14e-3 have decided the issue. The SEC has pointed out, however, that even if the courts were to impose a scienter requirement under section 14(e), it would not provide a legitimate basis for invalidating Rule 14e-3. Instead, the SEC urges that the scienter element should merely be read into the rule in the same fashion as the Supreme Court did in the *Ernst* decision.

X. THE "IN CONNECTION WITH" LIMITATION

Section 14(e) proscribes fraudulent practices "in connection with any tender offer." The SEC's rulemaking directive to define and prescribe means to prevent such fraudulent acts and practices is, therefore, expressly limited to conduct "in connection with" a
tender offer. With this limitation presumably in mind, the SEC set forth various prohibitions which are triggered once a tender offer has commenced or "a substantial step or steps" have been taken to commence a tender offer.\textsuperscript{128} According to the SEC, the prohibitions of the rule apply to the period from the accomplishment of the first substantial step or steps to the termination of the tender offer.\textsuperscript{129}

Challengers of Rule 14e-3's validity have great difficulty reconciling the "in connection with" language of section 14(e) with the SEC's regulation under Rule 14e-3 of pre-tender offer trading activities.\textsuperscript{130} First, they recall that the Supreme Court on several occasions has identified the sole purpose of section 14(e) to be the protection of investors who are confronted with a tender offer.\textsuperscript{131} If that is the sole purpose of the provision, then the "in connection with" language logically should be read to apply only upon actual commencement of a tender offer.\textsuperscript{132}

Secondly, critics assert that the express language of section 14(e) should be given strict meaning.\textsuperscript{133} Thus, the phrase "in connection with a tender offer" should be construed in the same manner as the phrase "in connection with the purchase or sale of any security" under section 10(b) and Rule 10b-5.\textsuperscript{134} Such a reading would require

\textsuperscript{128} The SEC acknowledges that the "substantial step" standard is not entirely objective. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,458 n.33. It attempted to provide some guidance by enumerating a non-exclusive list of activities which would constitute a "substantial step." Id. These include:

- voting on a resolution by the offering person's board of directors relating to the tender offer;
- the formulation of a plan or proposal to make a tender offer by the offering person or the person(s) acting on behalf of the offering person; or
- activities which substantially facilitate the tender offer such as: arranging financing for a tender offer; preparing or directing or authorizing the preparation of tender offer materials; or authorizing negotiations, negotiating or entering into agreements with any person to act as a dealer manager, soliciting dealer, forwarding agent or depository in connection with the tender offer.

\textsuperscript{129} Id. at 83,458 n.33.

\textsuperscript{130} See Gruenbaum, supra note 46, at 355; Heller, supra note 46, at 542-43; Poser, supra note 19, at 1285-96; Wang, supra note 81, at 306-08.

\textsuperscript{131} Piper v. Chris-Craft Industries, Inc., 430 U.S. 1, 35 (1977); Rondeau, 422 U.S. 49, 58 (1975). See also supra text accompanying notes 16 and 17 (discussion of the Supreme Court's decision in Piper and Rondeau).

\textsuperscript{132} See D. LANGEVOORT, supra note 37, § 7.01, at 194.

\textsuperscript{133} See, e.g., Gruenbaum, supra note 46, at 355; Heller, supra note 46, at 542-43.

\textsuperscript{134} See Heller, supra note 46, at 542. According to the author of the article, § 10(b) violations will only be upheld if the fraud occurs "in or close to the actual purchase or sale of the security." Id. The leading case addressing the "in connection with" requirement under Rule 10b-5 is SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) cert. denied" 394 U.S. 976 (1969), which held that the "in connection with" language referred to information upon which a reasonable investor would rely in actually purchasing or selling securities. See also Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2nd Cir. 1952), cert. denied, 343 U.S. 956 (1952) (§ 10(b) standing for actual purchasers or sellers only). Regarding § 14(e), see Frankel v. Slotkin, 705 F. Supp. 105 (E.D.N.Y. 1989), where the court held that the defendant's actions,
that there be an actual tender offer for a section 14(e) violation to occur.\textsuperscript{138} Most commentators concede that this interpretation should not mean that all pre-tender offer activity goes with impunity; rather, they contend that a tender offer must eventually commence for the statute and its implementing rule to have legal effect.\textsuperscript{139}

Several courts have supported this view. For example, the Second Circuit in \textit{Lewis v. McGraw}\textsuperscript{137} held that where no proposed tender offer had ever been made to the shareholders of a target company, those shareholders could not state a cause of action under section 14(e).\textsuperscript{138} Noting that section 14(e)'s sole purpose, according to the Supreme Court, is to protect investors "confronted" with a tender offer, the \textit{Lewis} court concluded that investor reliance is a necessary element under section 14(e).\textsuperscript{139} The court concluded that the target shareholders in that case, having not been presented with a tender offer proposal, could not demonstrate reliance.\textsuperscript{140} This same theory was utilized in \textit{Panter v. Marshall Field & Co.},\textsuperscript{141} where a takeover attempt in the form of a merger proposal was ultimately withdrawn. That court concluded that there could be no violation of section 14(e) because the shareholders were never afforded the opportunity to evaluate the merger transaction.\textsuperscript{142}

The SEC's response to this line of attack upon the rule's validity is that section 14(e)'s intended purpose is much broader than the rule's critics maintain because it includes protections against "unfair
disparities in market information” and “market disruption.”\textsuperscript{143} In the adopting release, the SEC justified the rule’s pre-tender offer reach, stating that insider trading “prior to the commencement of a tender offer results in the same abuses and causes the same detrimental effects as trading during a tender offer.”\textsuperscript{144} Under this effects-oriented approach, the SEC concluded that the protective scope of section 14(e) encompasses pre-tender offer conduct.\textsuperscript{145}

The SEC’s position has judicial support. In \textit{O’Connor & Associates v. Dean Witter Reynolds, Inc.},\textsuperscript{146} the court found that insider trading on the basis of nonpublic information concerning an impending tender offer was among the activities section 14(e) was designed to prohibit.\textsuperscript{147} The court stressed that even if a tender offer never actually takes place, a violation may still occur.\textsuperscript{148} In upholding the validity of Rule 14e-3, the court determined that the denial of information regarding an impending tender offer proposal would operate to the detriment of target shareholders and, therefore, was within the broad protections of the Williams Act.\textsuperscript{149} It seems reasonable that as long as the trading misconduct relates to a tender offer, it is not necessary that the tender offer have actually commenced, or even that it eventually takes place, for liability to attach under Rule 14e-3.

\section*{XI. Anti-Tipping Provision of the Rule}

Rule 14e-3 contains a general anti-tipping provision which complements the “disclose or abstain from trading” portion of the rule.\textsuperscript{150} This provision bars certain specified persons from selectively

\begin{footnotesize}
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\item 143. Release No. 34-17120, supra note 20, ¶ 82,646, at 83,457.
\item 144. \textit{Id.} at 83,458.
\item 145. \textit{Id.} at 83,458-59.
\item 146. 529 F. Supp. 1179 (S.D.N.Y. 1981). \textit{O’Connor} involved a planned takeover by Standard Oil of California, Inc. (Socal) of Amax, Inc. (Amax). \textit{Id.} at 1182. Apparently, inside information was leaked by corporate insiders to customers and registered representatives of a broker-dealer firm. \textit{Id.} The customers and registered representatives then apparently purchased Amax call options while in possession of the nonpublic proposed merger information. \textit{Id.} The plaintiff, a professional trader that sold Amax call options during the same period, sued the broker-dealer firm and its selling customers under § 10(b), Rule 10b-5, § 14(e) and Rule 14e-3. \textit{Id.}
\item 147. \textit{Id.} at 1190-93.
\item 148. \textit{Id.}
\item 149. \textit{Id.} at 1191. The \textit{O’Connor} court explained that “[t]he person trading on the basis of the information stands to gain precisely because of the impending announcement of the tender offer proposal, whether through a future tender or through an open market sale. The loss suffered by the target shareholder - seller is the direct result of the lack of knowledge of the proposed tender offer.” \textit{Id.} Notably, the court distinguished the \textit{Lewis} decision reasoning that it really involved the question of investor reliance and injury when defensive efforts successfully prevented the actual tender offer and whether such circumstances fell within the scope of § 14(e). \textit{Id.} at 1192-93.
\item 150. 17 C.F.R. § 240.14e-3(d). See supra note 5 (text of rule 14e-3). See also D.
\end{itemize}
\end{footnotesize}
divulging material, nonpublic information relating to a tender offer to any other person when it is reasonably foreseeable that the transmission of such information is likely to result in a violation of the rule.\textsuperscript{151} The specified persons subject to the rule include persons who create the nonpublic information (i.e., insiders of the bidder or target company) and persons who acquire the nonpublic information from insiders (i.e., "tippees").\textsuperscript{152} The prohibition contains a limited exception, so that communications made in good faith to officers, directors, employees, agents or advisors of the bidder or the target company in planning, financing or executing the tender offer will not violate the rule.\textsuperscript{153}

The primary criticism of the anti-tipping provision is that it creates liability in the absence of an actual trade or a personal benefit inuring to the tipper.\textsuperscript{154} The first objection is premised on the notion that a Rule 14e-3 violator must breach a duty to "disclose or abstain from trading."\textsuperscript{155} The mere passage of information from tipper to tippee absent an actual trade by either does not breach that duty and, instead, demonstrates that such persons have adhered to the "abstain from trading" portion of the rule. Therefore, such conduct cannot support a violation of the rule.\textsuperscript{156}

The second objection to the anti-tipping provision has received equal, if not greater, attention. In short, critics argue that the broad prohibition is directly at odds with the Supreme Court's interpretation of tipping liability in \textit{Dirks v. SEC}.\textsuperscript{157} In \textit{Dirks}, the Court held

\begin{itemize}
  \item \textsuperscript{151} See Release No. 34-17120, supra note 20, ¶ 82,646, at 83,463-64. It must be "reasonably foreseeable" to the violator that the recipient of the information either will make an unlawful trade or will unlawfully tip someone else. \textit{Id.} The SEC explained that the prohibition "is not intended to have an impact on casual and innocently motivated social discourse." \textit{Id.} at 83,463. Factors, among others, to be considered in determining if reasonably foreseeable violative conduct will follow include the identity, position, reputation or prior actions of the participants. \textit{Id.} The test is what a reasonable man would view as reasonably foreseeable. \textit{Id.}
  \item \textsuperscript{152} 17 C.F.R. § 240.14e-3(d) (1988). \textit{See supra} note 5 (text of rule 14e-3). The tippee doesn\'t have to acquire the information directly from the insider; instead, the information can be received through a chain of tippees originating with the insider. \textit{See} Release No. 34-17120, \textit{supra} note 20, ¶ 82,646, at 83,463-64.
  \item \textsuperscript{153} \textit{See also} Release No. 34-17120, \textit{supra} note 20, ¶ 82,646, at 83,464. The good faith exception also includes communications made pursuant to statutory or regulatory requirements. \textit{Id.}
  \item \textsuperscript{154} \textit{See} D. \textit{Langevoort}, \textit{supra} note 37, § 7.05, at 198; \textit{ABA Task Force Report, supra} note 81, at 251. \textit{See also} Peloso & Krause, \textit{supra} note 81, at 948.
  \item \textsuperscript{155} \textit{See supra} text accompanying note 38 (discussion of the adoption of Rule 14e-3).
  \item \textsuperscript{156} \textit{See} D. \textit{Langevoort}, \textit{supra} note 37, § 7.05, at 198; \textit{ABA Task Force Report, supra} note 81, at 251.
  \item \textsuperscript{157} 463 U.S. 646 (1983). Mr. Dirks was a registered broker dealer who was "tipped" by a former employee of Equity Funding Corporation that the company's profits were attributable in large part to fraud. \textit{Id.} at 649. The former employee was honorably motivated by a desire to expose the fraud and did not receive any remu-
that in order to sustain a Rule 10b-5 violation, it must be shown that: (i) the tipper personally benefitted, directly or indirectly, when he disclosed the information to the tippee; and, (ii) the tippee knew, or should have known, that the tipper's communication was in breach of a fiduciary duty owed to shareholders. In so holding, the Court expressly rejected an "equal access" to information theory, finding no evidence of legislative intent to support such a doctrine.

The SEC defends the anti-tipping provision of Rule 14e-3 on the grounds that it is consistent with both its rulemaking power and the general purposes of the Williams Act. First, the SEC points to its rulemaking authority to both define fraud and to "prescribe means reasonably designed to prevent" fraud. Thus, the prohibition on tipping is viewed as a reasonably designed means to curtail insider trading. In the adopting release, the SEC stated that the anti-tipping "formulation is reasonably related to the objective of preventing trading on the basis of material, nonpublic information because it operates to prohibit leaks which are the source of this information." Further, the SEC urges that, by seeking to prevent the selective dissemination of nonpublic information, the anti-tipping rule furthers section 14(e)'s general purposes of avoiding unfair disparities in market information and market disruptions caused when leaks occur. This rationale is consistent with a more expansive view of the protective scope of section 14(e).

XII. ANALYSIS

When the Supreme Court in Schreiber described section 14(e) as being "modeled" on section 10(b) and Rule 10b-5, did it intend that all of the requisite fraud elements under the latter provisions be applied with equal force to the former provision? If the same definition of fraud does, in fact, apply under section 14(e), hasn't

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158. Id. at 649-50 and 650 n.3. Dirks undertook his own investigation and corroborated the accusation. Id. at 649-50. He then contacted the SEC and the Wall Street Journal in hopes of uncovering the fraud; however, neither responded immediately. Id. He then informed his clients of the nonpublic investigatory information he had obtained. Id. at 650. The clients sold their holdings. Id. Thereafter, the stock price of Equity Funding fell precipitously. Id. Mr. Dirks was censured by the SEC for aiding and abetting a securities violation. Id. at 650-51. The Supreme Court reversed the SEC's sanctions and vindicated Mr. Dirks. Id. at 665-67.

159. Id. at 656-58. See also Peloso & Krause, supra note 81, at 948.

160. See supra text accompanying notes 57-58 (discussion of broad authorization to define fraud and prescribe means to prevent fraud).

161. Release No. 34-17120, supra note 20, ¶ 82.646, at 83,463.

162. Id. For a discussion of the SEC's purpose in adopting Rule 14e-3, see supra text accompanying note 51.

the SEC exceeded its rulemaking authority in defining as fraudulent a multitude of practices that section 10(b) and Rule 10b-5 caselaw has found to be perfectly legal?164 Challengers to the validity of Rule 14e-3 answer each of these questions in the affirmative. They contend that the lack of a breach of duty requirement under the rule flies in the face of Chiarella,165 the lack of a scienter requirement flies in the face of Ernst,166 the lack of an actual tender offer requirement flies in the face of Lewis and Panter,167 and the lack of a "personal benefit" requirement for "tipping" liability flies in the face of Dirks.168 In short, these critics cogently argue that the rule is impermissibly broader than the judicially interpreted statute it was intended to implement.

The SEC's response to these challenges, first and foremost, is that an in pari materia statutory interpretation of sections 10(b) and 14(e) is inappropriate. It points to the separate and distinct legislative objectives of the two antifraud provisions.169 The SEC reminds the rule's critics that section 10(b) and its progeny, Rule 10b-5, were adopted as general "catch-all" provisions against a backdrop devoid of legislative guidance.170 It is only through judicial interpretations that these general antifraud provisions have been imbued with common law fraud principles.171 In significant contrast, argues the SEC, section 14(e) was adopted not as a "catch-all" provision, but with a precise legislative mandate in mind: ensure complete and timely disclosure of material information relating to tender offers.172 This specific Williams Act purpose, it is urged, prompted Congress to confer a different and broader level of rulemaking authority upon the SEC.173 This construction is substantiated, according to the

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164. See, e.g., D. Langevoort, supra note 37, § 7.05, at 194.
169. See supra text accompanying notes 70-73 (discussion of Rule 14e-3 as being separate and distinct from Rule 10b-5). See also Chestman Appellate Brief, supra note 59, at 51-54.
171. See supra text accompanying note 78 (discussion of Chiarella). See also Chestman Appellate Brief, supra note 59, at 49.
173. See supra text accompanying notes 51-58 (discussion of the breadth of SEC's rule-making authority). See also Chestman Appellate Brief, supra note 59, at 50.
SEC, by the literal language of section 14(e) as well as the recent congressional ratifications of Rule 14e-3. Moreover, the SEC points to the O'Connor, Chestman and Marcus Schloss & Co. decisions, as refuting the substantive challenges to the rule and unequivocally confirming its validity.

As a matter of statutory construction and in view of the distinguishable legislative backdrops of sections 10(b) and 14(e), the in pari materia theory rests on somewhat shakeable grounds. Courts which have applied the theory may have elected this approach because Rule 10b-5’s ample caselaw contributed to an expedient disposition of the issues in a Rule 14e-3 case. Yet, expediency should not substitute for sound reasoning. Better reasoning dictates that the Schreiber court’s observation regarding the “modeling” of section 14(e) after section 10(b) and Rule 10b-5 should not be given such a pervasive meaning and application.

On the other hand, it is equally compelling that the SEC should not be allowed to circumvent a Supreme Court finding by simply promulgating a rule under a different statutory section which reaches the same conduct. Suppose, for example, that the Supreme Court ruled that a de minimis exception applied to the Rule 10b-13 prohibition on a bidder’s purchases outside of a tender offer. Could the SEC, in response, adopt a new Rule 14e-4 defining as a “manipulative act” under section 14(e) any purchase (material or not) by a bidder outside of a tender offer? Again, the better reasoning says no. From a policy standpoint, therefore, Rule 14e-3’s validity may be called into question.

In sum, the Williams Act legislators declined to define “insider trading,” leaving the matter to the regulators and the courts. The Supreme Court has set forth its general definition principally through section 10(b) and Rule 10b-5 caselaw. The SEC has set forth its version, in the context of tender offers, through the adoption of Rule 14e-3. Unfortunately, the two definitions don’t coincide. The resulting incongruity has created a potential “loophole” for Rule 14e-3 violators. As a disturbing affirmation of this fact, validity

174. See supra text accompanying notes 59-66 (discussion of arguments relating to congressional ratification of Rule 14e-3). See also Chestman Appellate Brief, supra note 59, at 47-48.
176. United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491). But see id. at 10 (Mahoney, J., dissenting in part) (rule 14e-3 was an invalid exercise of SEC rule making authority).
178. 17 C.F.R. § 240.10b-13 (1988). Note, however, Rule 10b-13 was adopted under both § 10(b) and § 14(e) and concerns “manipulation” not “fraud”. Id.
challenges of the genre introduced in Chestman\textsuperscript{179} and Marcus Schloss\textsuperscript{180} can be expected to emerge as standard defense material in future Rule 14e-3 enforcement and civil actions.

XIII. RECOMMENDATION

In the midst of this debate, one inescapable conclusion surfaces: the validity of Rule 14e-3 cannot remain unsettled. Until the rule’s validity is liberated from doubt, it cannot operate as a truly effective deterrent to undesirable insider trading activities involving tender offers. The quarrel over Rule 14e-3’s validity may not be satisfactorily resolved until the matter is taken up on appeal before the Supreme Court. Of course, the timing of such an appeal, and the likelihood of a \textit{writ of certiorari} being granted, is difficult to predict.\textsuperscript{181} Perhaps, a more immediate measure makes sense.

Because the primary focal point of the debate over the rule’s validity centers on the legislative intent surrounding section 14(e), a Congressional response is seemingly necessary. To that end, clarifying legislation which defines with precision the intended boundaries of prohibited conduct under section 14(e) is strongly warranted.\textsuperscript{182} Whether such legislation codifies the common law fraud principles developed by the Supreme Court under section 10(b) and Rule 10b-5, or simply reaffirms the SEC’s adopted fraud definition under Rule 14e-3, may be of lesser importance than the result of creating legal certainty where an alarming degree of uncertainty presently exists.

\textsuperscript{179} United States v. Chestman, No. 89-1276 (2d Cir. May 2, 1990) (1990 WL 57491).
\textsuperscript{181} The separate views of the three appellate judges in Chestman on the rule, 14e-3 counts and the related policy implications suggest that the Chestman decision is ripe for appeal to the Supreme Court.
\textsuperscript{182} See ABA Task Force Report, supra note 81, at 252-53 (Appendices A and B to that report suggest Alternative Legislative Proposals); Phillips, supra note 67, at 848.