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This Little Piggy Went To Market: The Regulation of Risk Arbitrage After Boesky

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INTRODUCTION

$100 million. That is what Ivan Boesky paid the United States as part of a negotiated settlement to charges of inside trading.[1] The Boesky and related securities fraud scandals[2] focused unprecedented

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[1] SEC v. Boesky, SEC Litigation Release No. 11,288 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov. 14, 1986). The SEC brought an enforcement action against Ivan Boesky alleging that he purchased securities based on material, nonpublic information provided to him by Dennis Levine. *Id.* at 94,857. As part of the settlement in this action, Boesky paid the United States $50 million representing disgorgement of profits obtained from inside trading and $50 million representing a civil penalty under the Insider Trading Sanctions Act. *Id.* at 94,856 to 94,857. In addition, Boesky pled guilty to a felony and was permanently barred from the securities industry. *Id.* at 94,858. Boesky was sentenced to a three-year prison term on the felony conviction. *Boesky Sentenced to Three Years, Judge Stresses General Deterrence*, 19 Sec. Reg. & L. Rep. (BNA) No. 51, at 1951 (Dec. 25, 1987). Even before Boesky's legal difficulties became public, he was known in the industry as "piggy" because of the scope of his trading activities.

Partly as a consequence of its activities with Boeksy, Drexel Burnham Lambert Inc. agreed to plead guilty to six counts of mail, wire, and securities fraud, and to pay $650 million in fines and penalties. *U.S. Attorney Formally Charges Drexel With Massive Stock Fraud Scheme*, 21 Sec. Reg. & L. Rep. (BNA) No. 4, at 151 (Jan. 27, 1989). Of the payment, $300 million was allocated to criminal fines and civil penalties, while $350 million was allocated to an escrow account to pay private claims. *Id.*

[2] *See* D. LANGEVOORT, INSIDER TRADING REGULATION 2 (1988). Mr. Boesky was "engaged in the risk arbitrage business, through which he and related entities invested in the stocks of publicly traded companies, including those involved in mergers, takeovers, and other changes of ownership." Arden Way Assocs. v. Boesky, 660 F. Supp. 1494, 1495 (S.D.N.Y. 1987). Ivan Boesky was engaged in risk arbitrage activities since 1966. *See* Sperber v. Boesky, 672 F. Supp. 754 (S.D.N.Y. 1987), *aff'd*, 849 F.2d 60 (2d Cir. 1988). According to the *Sperber* court, which dismissed the investors' action seeking RICO treble damages as a result of Boesky's illegal inside trading practices, Mr. Boesky had "spotty success" until 1982 at which time he became extraordinarily successful. *Id.* at 755. This "extraordinary success" continued until November, 1986—the date the SEC announced the Boesky investigation. *Id.*

Dennis Levine also was a cohort in the Boesky "scandal." Levine, a managing director at Drexel Burnham was charged with tipping material inside information to Boesky concerning mergers and other acquisitions. SEC v. Levine, SEC Litigation Release No. 11,095 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,717 (S.D.N.Y. May 21, 1986). Approximately one month later, Levine settled this action by consenting to pay $10.6 million which he had on deposit at a Bahamian bank. SEC v. Levine, SEC Litigation Release No. 11,117, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,761, at 93,703 (S.D.N.Y. June 18, 1986). He also agreed to disgorge an additional $1 million in assets and an injunction was issued prohibiting him from violating sections 10(b) and 14(e) in the future. *Id.*

In a related fraud scandal, termed the "yuppie" ring, four tippees pled guilty to receiving attention on the corporate restructuring phenomenon in general and risk arbitrage[3] in particular. Much of the considerable public unease over the scope of corporate restructuring focused on the role risk arbitragers play in fueling the market for corporate control. Risk arbitragers also played some role in triggering the stock market break of October 19, 1987.[4] This article explores the debate over risk arbitrage spawned by the Boesky scandal and the October 19th event. The debate primarily concerns the proper role federal securities law should play in regulating risk arbitrage.

Risk arbitragers are major participants in the control transaction marketplace.[5] They "bet" on whether a control transaction will suc-

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material, nonpublic inside information from former Paul, Weiss, Rifkind, Wharton & Garrison law firm associate Michael David. *Guilty Pleas Entered in Lawyer, 'Tippee' Insider Trading Scheme*, 18 Sec. Reg. & L. Rep. (BNA) No. 23, at 794 (June 6, 1986). One of the four, Morton Shapiro, a stockbroker, was sentenced to two months in prison and fined $25,000. *Federal Court Sentences Two Figures in Yuppie Five Insider Trading Scheme*, 19 Sec. Reg. & L. Rep. (BNA) No. 10, at 336 (Mar. 6, 1987). An investor, Daniel Silverman, was sentenced to three years probation, a $25,000 fine and 200 hours of community service. *Id.* Robert Salsbury, a former research analyst at Drexel Burnham Lambert, was sentenced to three years probation. *Id.* at 337. The fourth tippee, Andrew Solomon, also was placed on probation. *Id.* The tipper, Michael David, settled his SEC charges and consented to fines of $150,000. *Id.* In addition to the SEC action, Boesky is a defendant in numerous lawsuits. *See, e.g.*, Rubin v. Posner, 701 F. Supp. 1041 (D. Del. 1988) (denying motions to dismiss by defendants Posner, Boesky, and Drexel Burnham relating to shareholders' derivative suits alleging section 10(b) and rule 10b-5 violations); *Arden Way*, 660 F. Supp. 1494 (action by 42 plaintiff/limited partners in Ivan F. Boesky & Co. claiming they were defrauded in their purchase of limited partnership interests); *In re* Ivan F. Boesky Sec. Litig., 120 F.R.D. 624 (S.D.N.Y. 1988) (relating to securities fraud action against brokerage firms Kidder Peabody & Co. Inc., Drexel Burnham Lambert Inc., and Goldman, Sachs & Co. as control persons, and as Boesky conspirators, for illicit inside trading); SEC v. Kidder Peabody & Co., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,271 (June 4, 1987) (enforcement action for trading in securities based upon material, nonpublic information from arbitrager in investment banking firm, and for illegally "parking" Boesky securities).

[3] Ivan Boesky defines risk arbitrage as "the taking advantage of the disparity of value that exists between two different but related securities that are trading simultaneously in the same or different markets, or the disparity between the market price and the cash price being offered." I. BOESKY, MERGER MANIA ARBITRAGE: WALL STREET'S BEST KEPT MONEY-MAKING SECRET 14 (1985). Boesky also defines and discusses classic arbitrage, *id.* at 16-20, and merger arbitrage, *id.* at 20-23. *See also* Derven, *Martin D. Sass on Merger Arbitrage*, 22 PENSION WORLD 20-22 (Oct. 1986) (discussing merger arbitrage).

[4] REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS, at III-2 (Jan. 12, 1988) [hereinafter BRADY REPORT]. The Brady Report was designed to determine the most appropriate regulatory responses to ensure a sound market and to protect investors. *Id.* at v; Smith, Swartz & Anders, *Black Monday: What Really Ignited the Market's Collapse After Its Long Climb*, Wall St. J., Dec. 16, 1987, at 1, col. 6; SEC DIVISON OF MARKET REGULATION, THE OCTOBER 1987 MARKET BREAK, at 2-11 to -12 (Feb. 9, 1988) [hereinafter MARKET BREAK STUDY].

[5] Competition has grown in the risk arbitrage business. By the middle of 1981, some $3 billion was invested in risk arbitrage activities. Brown & Raymond, *Risk Arbitrage and the Prediction of Successful Corporate Takeovers*, FIN. MGMT., Aug. 1986, at 54. As the market for corporate control grew, so did the resources available to risk arbitragers, partially as a result of Ivan

ceed, making or losing millions on a single deal.[6] Up to five percent of the profit from control transactions accrues to arbitragers.[7] For successful risk arbitrage positions, returns in excess of sixty percent on an annualized basis are not uncommon.[8] Arbitragers' activities are often "critical to the success of tender offers."[9]

In regulating risk arbitrage, Congress and the Securities Exchange Commission (SEC) must consider the impact of their efforts on the beneficial effects of the business. The legitimate functions of risk

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Boesky's marketing of risk arbitrage investment pools. *Id.* Institutional investors became significant sources of risk arbitrage capital. Hansell, *Arbitrage Like It Oughta Be*, 22 INSTITUTIONAL INVESTOR, Apr. 1988, at 73-74. The pool of money devoted to risk arbitrage reached $15 billion in 1987. The October 1987 stock market crash and the Boesky scandal probably reduced risk arbitrage funds substantially. According to Mr. Hansell, the pool of risk arbitrage money available has fallen to $6 billion. *Id.* After Boesky, the major players in risk arbitrage remained the traditional Wall Street firms such as Goldman Sachs & Co. and Bear Stearns Co. as well as several private investment partnerships. Anders, *Takeover Buffet Is So Big Even Arbitragers Are Full*, Wall St. J., Oct. 20, 1988, at C16, col. 1. As of the fall of 1988, while estimates of the amount of funds varied widely, the consensus was that some $10 billion of buying power was available to risk arbitragers. *Id.* Because of a flurry of huge transactions in October 1988, it was believed that the buying power of risk arbitragers was nearing capacity. As a consequence, takeover stocks were selling at an abnormal discount from the announced acquisition price. *Id.* at C12, col. 1.

[6] Published reports indicated, for example, that Ivan Boesky profited $65 million in the Socal-Gulf deal and $50 million in the Getty-Texaco transaction. Bruck, *"My Master is My Purse,"* ATLANTIC MONTHLY, Dec. 1984, at 96; *see also* I. BOESKY, *supra* note 3, at 3-11 (discussing the Getty-Texaco deal). When Gulf terminated its effort to take over Cities Service, however, Boesky lost $13.7 million. Bruck, *supra*, at 102. When the Mesa efforts to gain control of Phillips terminated, it appears that Boesky lost $30 to 40 million. In the days after the Boesky scandal became public, arbitragers as a group lost well over $100 million.

[7] Poulsen, *Estimate of the Portion of Stock Market Profits Arising from Corporate Takeovers Over the Past Three Years That Has Accrued to Risk Arbitrageurs, reprinted in Regulating Hostile Corporate Takeovers: Hearings on S. 227, S. 678, S. 1264, S. 1323, S. 1324 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. 478-91 (1987). The amount of the transaction premium accruing to risk arbitragers has probably increased in recent years as the amount of available capital devoted to this activity has increased. This trend does not necessarily mean that, on a capital-adjusted basis, risk arbitrage has become more profitable. Some evidence suggests, in fact, that before the Boesky scandal became public, competition among risk arbitragers reduced profits for this industry segment.

[8] As of October 1988, the stock market for the year was up some 13%. Arbitragers' gains for the year, however, typically amounted to 40% to 60%. Smith, Swartz & Anders, *supra* note 4. In one ten-month period Ivan Boesky's trading partnership earned 44% on invested capital; in another fiscal year, his firm made 296% on invested capital. In other less successful years Boesky's firm suffered net losses. *Id.*

[9] *The Proper Roles of Government and of Self-Regulation in Light of the Shift in Policy Focus of the SEC in the Past Few Years: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 100th Cong., 1st Sess. 275-76 (1987) (Responses to Recommendations and Questions, by Harvey Pitt). Mr. Pitt suggested that "Congress should *not* consider legislation that essentially eliminates risk arbitrage in battles for corporate control" because such activities create beneficial market liquidity and shift risk. *Id.* at 275 (emphasis in original). Rather, he recommended that registration or reporting obligations for risk arbitragers might be appropriate. *Id.*

arbitrage are three fold. First, arbitragers create market liquidity.[10] Second, they bear risk for investors with low risk preferences.[11] These investors can sell into the market for a profit, at a substantial fraction of the proposed transaction price as a consequence of risk arbitrage activity. Third, the trading of arbitragers creates market efficiency,[12] signalling accurately the eventual success of the transaction. Risk arbitragers, when they tender, receive compensation equal to the spread between their purchase price and the transaction price. The spread compensates the arbitrager for bearing risks that a transaction will not close timely or profitably, or that it ultimately will fail to close.[13]

Three major types of securities regulations affect risk arbitrage: (1) the prohibitions on inside trading arising under SEC rules 10b-5[14] and 14e-3;[15] (2) the federal margin[16] and net capital rules;[17] and (3)

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[10] *See* I. BOESKY, *supra* note 3, at 19 (explaining that arbitragers create liquidity because they "buy currency when most people are unwilling to do so").

[11] *Id.* at 21.

[12] *Id.*

[13] *See id.* at 3-11. In his introduction, Boesky explains these risks by discussing Texaco's purchase of Getty Oil and by providing his perspective of the underlying events leading up to that merger.

[14] 17 C.F.R. § 240.10b-5 (1988). Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . ,
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> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Id.

[15] *Id.* § 240.14e-3. Rule 14e-3 provides in relevant part:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer . . . , it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from . . . [the offeror, the issuer, or any person acting on their behalf] to purchase or sell . . . any of such 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.

Id. § 240.14e-3(a); *see infra* note 180 (providing relevant language to demonstrate when the 14e-3 duty to disclose arises).

[16] *See* 15 U.S.C. § 78g (1982 & Supp. V 1987); *see also* Dennis, *Risk Arbitrageurs and the Market for Corporate Control* (Book Review), 37 HASTINGS L.J. 409, 422-26 (1985) (reviewing Boesky's book, *Merger Mania Arbitrage: Wall Street's Best Kept Money-Making Secret*, and discussing federal margin rules); Fishe & Goldberg, *The Effects of Margins on Trading in Futures*

the Williams Act affirmative disclosure and timing-proration rules.[18] Whatever their salutary effects, each of these regulatory programs reduce the potential return of arbitragers and, thus, the incentive to undertake the activity. The current regulatory solutions attempt to allow the legitimate functions of risk arbitrage to proceed while not allowing arbitragers to obtain supernormal profits or create other adverse market effects. This article examines the utility of the current solutions and proposed changes in regulation[19] in light of the benefits and costs of risk arbitrage.

I. THE BUSINESS OF RISK ARBITRAGE

Until recently, risk arbitrage took place out of public view. The business was mainly the province of a limited number of major investment firms such as Goldman Sachs.[20] As the market for corporate control grew, so did the prominence of risk arbitragers in that market. Much of the public attention given to risk arbitragers both before and after the recent Wall Street scandal came from the activities of Ivan Boesky. Boesky was the first risk arbitrager to develop investment limited partnerships that focused on risk arbitrage activities.[21] These partnerships gave the public an opportunity to indirectly

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Markets, 6 J. FUTURES MARKET 261 (1986) (discussing the pros and cons of increased governmental margins regulations).

[17] 17 C.F.R. §§ 240.15c3-1 to .15c3-3 (1988). The net capital rules regulate broker-dealers and require them to maintain a ratio between net worth and liabilities. Rule 15c3-1 provides that "[n]o broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1,500 percent of his net capital." *Id.* § 240.15c3-1(a). The net capital rules are the longest rules promulgated by the SEC. They are complex and contain other net capital requirements regulating various activities of broker-dealers. For example, rule 15c3-1(a)(5) provides for additional capital requirements for brokers or dealers engaged in selling options. *Id.* § 240.15c3-1(a)(5).

[18] *See* 15 U.S.C. § 78n(d) (1982); 17 C.F.R. § 240.13d (1987). Rule 13d-1 generally provides that any person deemed to be the beneficial owner of five percent or more of an equity security of an issuer must file a statement in compliance with Schedule 13D. *Id.* § 240.13d-1(a).

The proration rule is derived from section 14 of the 1934 Act, Securities Exchange Act of 1934, § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1982), and provides that when a partial tender offer is oversubscribed, "the securities taken up shall be taken up as nearly as may be pro rata, . . . according to the number of securities deposited by each depositor." 17 C.F.R. § 240.14(d)(6)(e)(vi) (1988).

[19] *See* MARKET BREAK STUDY, *supra* note 4, at 3-1 to -34. The study explores various regulatory responses including proposals relating to derivative product leveraging, price limits, short sale restrictions, reporting requirements, and record-keeping requirements. *Id.*

[20] For the early history of risk arbitrage, see Henry, *Activities of Arbitragers in Tender Offers*, 119 U. PA. L. REV. 466 (1971).

[21] *See In re* Boesky Sec. Litig. (Arden Way Assocs. v. Boesky), 669 F. Supp. 659 (S.D.N.Y. 1987); Arden Way Assocs. v. Boesky, 664 F. Supp. 855 (S.D.N.Y. 1987). Boesky instituted a reorganization plan of Ivan F. Boesky Corp. and its subsidiaries into limited partnerships, in order to engage in risk arbitrage activities. *Id.* at 856. Boesky raised $1 billion in investments through an integrated offering of the partnership's securities.

participate in risk arbitrage. Boesky prominently advertised that risk arbitrage was a way to profit greatly from the boom in the market for corporate control.

Data on the precise techniques of risk arbitrage are hard to obtain.[22] Much of the information remains proprietary. Ironically, despite dramatic events since 1985, the best description of legal risk arbitrage remains Boesky's book, *Merger Mania Arbitrage: Wall Street's Best Kept Money-Making Secret.*[23] In its basic form, risk arbitrage is a relatively simple, fundamental investment strategy.[24] Everything a risk arbitrager does focuses on finding and preserving a spread between the arbitrager's acquisition price and the ultimate price of the control transaction.[25]

A. *Risk Arbitragers' Valuation and Trading Techniques*

The first step in the risk arbitrage decision-making process is the valuation of the consideration offered in a control transaction. In an all-cash transaction this is obviously an easy task: shares purchased times the purchase price, reduced for the time value of the capital invested in the position equals the amount of consideration received by the risk arbitrager. In a partial tender offer,[26] in which the purchaser offers to buy less than all of the outstanding shares of the target, the arbitrager must assess how many of the shares he tenders actually will be purchased. Under the SEC's tender offer rules, if the offer is oversubscribed only a portion of each offeree's shares will be purchased.[27] The risk arbitrager must develop a view as to the "blended

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[22] For example, little is known about what sort of computer modelling and expert systems are used by risk arbitragers. Sender, *Information Technology: Risk Arbitrage Made Easier*, 21 INSTITUTIONAL INVESTOR, Feb. 1987, at 159-60.

[23] I. BOESKY, *supra* note 3. I reviewed the book in an essay written for *Hastings Law Journal.* Dennis, *supra* note 16. The printed word has a certain permanency that is disquieting. I wrote that "[n]o reported case holds a risk arbitrageur liable for trading on inside information, and the published literature on risk arbitrage barely discusses the problem." *Id.* at 417. Recently, descriptions of risk arbitrage discuss hardly anything else. Much of the following description of the business of risk arbitrage is derived from Boesky's book and my review of it.

[24] The classic study of fundamental analysis is B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUES (4th ed. 1962). Investors using fundamental trading strategies attempt to reach investment decisions based upon an assessment of the fundamental earnings value rather than technical factors such as past price movements.

[25] *See* I. BOESKY, *supra* note 3, at 24-36 (providing examples of basic risk arbitrage transactions locking in spreads).

[26] *See id.* at 100-03.

[27] *See* Securities Exchange Act of 1934 § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1982); 17 C.F.R. § 240.14(d)(6)(e)(vi) (1988).

value"[28] for the offer. This depends not only on the amount of securities actually purchased during the offer, but also on the value of the remaining securities after the offer.[29] If securities are part of the offered consideration, the post-transaction value of these securities also must be assessed.[30] Such a valuation may be difficult because often the offered instruments have not yet been traded publicly. Due to the risk associated with such instruments, usually debt instruments, they may trade shortly after issue at a deep discount from face value.[31]

During the second step, the arbitrager calculates the potential rate of return on the risk arbitrage position. This amount is affected by the taxability of gains on the sale as well as the timing of the transaction. The risk arbitrager's calculations might well turn on complex questions of federal taxation of corporate reorganizations.[32] The amount available and the cost of leverage also affects the risk arbitrager's net return. Because of the direct or imputed cost of capital, the longer the transaction remains open the lower the net return to the risk arbitrager. The effect of regulation on the cost of capital, the applicability of the federal margin rules,[33] the net capital rules of the SEC,[34] and the stock exchange rules on leveraging[35] will also affect the risk arbitrager's investment decision.[36]

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[28] *See* I. BOESKY, *supra* note 3, at 101-03.

[29] *Id.* at 101. Assume that an offeree tenders all 100 shares she owns. The offer is for only 50% of the outstanding shares, but 80% of the shares of the target are tendered. Only 62 shares of the tendering shareholders shares will be purchased. To assess the value of the offer, the shareholder must make certain assumptions about the post-transaction value of her remaining shares. *See id.* at 102.

[30] *See id.* at 30-35. Hedging is difficult in such transactions because a trading market on a "when issued" basis for a new type of security will develop late in the process.

[31] The RJR Nabisco leveraged buyout deal shows this effect. Part of the large spread that persisted between the stated deal price and the trading market for RJR stock was uncertainty over certain antitrust issues and over the value of the securities that were to be issued to fund part of the transaction.

[32] For example, some of the uncertainty surrounding the recent contest for Pillsbury centered on the taxability of competing offers. *See* Grand Metro. PLC v. Pillsbury Co., 704 F. Supp. 538 (D. Del. 1988). Often a key moment in a takeover battle will be when the IRS gives its view as to whether the transaction will be a tax-free exchange. The participants will usually seek a letter ruling from the IRS on this issue. Boesky devotes a considerable number of pages to description of the taxation issue. I. BOESKY, *supra* note 3, at 44-49, 206-33. Such a discussion only begins to describe the complexity of analysis in the tax area. In part, the risk arbitrager's trades will reflect the consensus judgment on the tax consequences before an IRS letter ruling is received, although variations in individual tax situations might make the consensus judgment difficult to ascertain only from the price of the securities in question.

[33] *See generally* Dennis, *supra* note 16, at 422-26 (discussing federal margin rules).

[34] 17 C.F.R. § 240.15c3-1 (1988).

[35] *New York Stock Exchange Inc., Operation of Member Organizations,* N.Y.S.E. Guide (CCH) ¶ 2431 (Sept. 1, 1968), *reprinted in* NEW YORK STOCK EXCHANGE, INC. CONSTITUTION AND RULES 3751 (1988).

[36] *See* I. BOESKY, *supra* note 3, at 41-44.

The simplest risk arbitrage trading strategy occurs in the any-and-all cash tender offer. This strategy is demonstrated by the following example. Assume that a target firm is trading before the announcement of a tender offer[37] for $50 per share. The proposed tender price is $60 per share. Upon the announcement of the offer, the price of the target will begin to rise rapidly toward the tender price. The price might easily reach $58 in a matter of hours. Even so the $2 spread, which reflects the risk that the deal may not close, may be sufficient to induce the risk arbitrager to invest in the target if he determines that the transaction is likely to close promptly. If no control transaction occurs, however, the price of the target firm's shares usually falls to a substantially lower price than the arbitrager's acquisition price. Often the price drops to almost as low as the preannouncement price. In our hypothetical case the price of the target could fall to $52 per share, leaving the risk arbitrager with a $6 loss per share.[38] The arbitrager must focus on whether the $2 potential gain is worth the $6 potential loss.

The chance that the control transaction will not close creates the major difference between risk arbitrage and classic arbitrage. In classic arbitrage, the purchase and resale occur simultaneously, locking in the spread and liquidating the positions.[39] In risk arbitrage, the positions must be maintained over long periods,[40] and if the control transaction falls apart, most of the spread disappears.[41]

In transactions in which the raider offers part or all of the consideration in its securities, the arbitrager's trading techniques become more complex. Risk arbitragers use hedging techniques to limit risk based upon factors other than those relating only to the control transaction.[42] Trading strategies based upon hedging in complicated

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[37] Boesky asserts that "the tender offer is the principal weapon in waging battle to acquire a company that will not agree to a merger." I. BOESKY, *supra* note 3, at 77. He further states that it is the "fastest of merger transactions." *Id.* He defines a tender offer as the "cash offer . . . made directly to the shareholders of another company in exchange for [their] stock." *Id.* at 78. As a consequence of the speed advantage, many consensual control transactions begin as tender offers.

[38] Once a target firm has been put in play, frequently its stock does not fall back completely to its prior levels. Some residual price increase persists. In a partial cash tender offer, even if successful, the risk arbitrager also faces proration risk.

[39] Traditional arbitrage occurs between markets, for example currency markets, where the trader attempts to equate values of the same item in the different markets. I. BOESKY, *supra* note 3, at 17-19.

[40] The increasingly complex market for corporate control, especially in light of state takeover statutes and more sophisticated defensive tactics, has practically extended the length of time required to complete transactions, particularly hostile transactions.

[41] In a cash-only deal, the shares of the target company stock will usually drop if the tender offer collapses, causing the same type of loss that usually occurs in the exchange offer.

[42] I. BOESKY, *supra* note 3, at 24-36, 146-68; *see* Henry, *supra* note 20, at 468.

underlying transactions become intricate. For some control transactions, only a seasoned professional trader can successfully undertake the necessary hedging program.[43] Hedged trading strategies may depend on the reduced transaction costs attendant to professional trading.[44]

One hedging technique involves the use of matched long and short sales. The risk arbitrager makes matched purchases and sales in long and short positions in different securities.[45] These positions are unwound when the offer becomes effective. The short sale position is liquidated with the consideration obtained from the control transaction. If the value of the acquiring firm's securities received in the control transaction has dropped during the period needed to close the deal, profits from the short sale preserve the risk arbitrager's compensation. To demonstrate the effect of hedging, assume that ABC corporation is making a one-for-one exchange offer for XYZ corporation. XYZ is trading for $25 per share; ABC is trading for $29. The $4 price difference—the spread—reflects risk that the deal will not be completed. An arbitrager can purchase one share of XYZ at $25 while selling short one share of ABC for $29. So long as the two stocks trade in tandem the arbitrager is unaffected even if XYZ and ABC then fall in value. If both stocks fall in value, profits from selling short ABC offset any loss in value from the long position in XYZ.[46] On the other hand, if the deal terminates, the losses from the long position in XYZ would exceed gains from the sale of the ABC short position. This occurs because XYZ will fall more rapidly than ABC toward its pre-deal price. Thus the risk arbitrager is able to ameliorate market risk but not deal risk.

Other hedging techniques include using options on the underlying

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[43] Dennis, *supra* note 16, at 413 n.20.

[44] *See* Henry, *supra* note 20, at 467. "Since most risk arbitragers are broker-dealers with seats on the New York Stock Exchange and other exchanges, they can avoid paying all commissions on trades except the specialist fee." Dennis, *supra* note 16, at 413 n.20.

[45] I. BOESKY, *supra* note 3, at 25-36. Hedging in the sense described here is not possible in cash offers because there is no equivalent security to be sold at the time the position is established. In an all-cash offer the spread is merely the difference between the current market price of the target's stock and the tender offer price. Even in all-cash offers, some systematic market risk hedging may be done through the purchase of stock market index futures. *See id.* at 163-64; Henry, *supra* note 20, at 467-71.

[46] For example, if the market as a whole drops in value, both stocks are likely to fall in value. Assume that the price of ABC stock falls to $26 and XYZ falls to $21 per share. The arbitrager sold ABC short at $29, but he will pay only $21 to liquidate that position, thus making an $8 profit from the short sale of ABC. The arbitrager, however, purchased one share of XYZ at $25, but he will only receive $21 to liquidate that position, resulting in a $4 loss on XYZ. Thus, by hedging, the arbitrager made a total profit of $4 despite the fall in the value of the stocks.

securities,[47] and stock and interest futures.[48] For example, an increase in interest rates across the economy as a whole will reduce the value of any debt securities issued in connection with the control transaction. Like a fall in the value of the raider's stock in a stock-for-stock control transaction, a fall in the value of the raider's newly issued debt instrument reduces the spread. This type of risk can be reduced through the purchase of a compensating interest-rate future. If the risk arbitrager takes a short position in an interest-rate future, the profits from liquidating that short position will offset any reduction in the value of the newly issued debt instrument.

As a consequence of October 19th, risk arbitrage hedging as well as other types of arbitrage hedging have become controversial. The effect on the financial markets of liquidation of arbitrage positions in response to proposed tax changes was magnified by the unwinding of hedged positions. These trades have been identified as a triggering event in the market break;[49] however, without hedging, the arbitrager would face unacceptable risk. The risk arbitrager would be buffeted not only by the risk that the control transaction may fail to close, but that during the pendency of the transaction, market-wide events may reduce the value of the transaction below that necessary to induce the investment.

B. *Risk Arbitragers' Evaluation Techniques Concerning Deal Risk*

Ultimately, the risk arbitrager links the data on valuing the consideration to be received with the information on the viability of the deal through a rate of return analysis.[50] The expected rate of return,

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[47] Standardized options are publicly traded on the Chicago Board Options Exchange, the NYSE, the AMEX, the Pacific Stock Exchange, and the Philadelphia Stock Exchange. If one of the deal stocks has a publicly traded standardized option, trading in the option may replace trading in the underlying security. Rather than selling short, the risk arbitrager can buy puts or sell calls. This strategy can increase the spread and reduce capital costs at the expense of increasing risk. I. BOESKY, *supra* note 3, at 156-57.

[48] The commonly traded standardized equity futures and options instruments are the Standard and Poor's 500 stock index, the Standard and Poor's 100 stock index, and the Major Market Index of 20 stocks. These instruments are derivative of the underlying equity securities and are settled in cash. Standardized trading also occurs in interest rate options on governmental securities. This allows the risk arbitrager to reduce the risk of price movements across the equity markets that reduce the value of the deal or economy-wide interest rate fluctuations that affect the value of any debt securities issued in the transaction.

[49] *See* Cohen, *Explaining the Events of October 1987*, in AFTER THE CRASH—LINKAGES BETWEEN STOCKS & FUTURES, at 11-16 (1988). Mr. Cohen was general counsel to the Brady Task Force.

[50] *See* W. KLEIN & J. COFFEE, BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 207-08 (3d ed. 1988).

reflecting considerable uncertainty, must be compared with alternative investments of similar risk.

The primary task of the risk arbitrager is to determine whether the proposed control transaction is viable. While risk arbitrage resembles other types of fundamental trading, the focus of the risk arbitrager is almost exclusively on whether the control transaction will be consummated. The traditional concern of fundamental trading—the long-run earnings capacity of the participating companies—is considered only secondarily to determining whether the control transaction is viable. As with any fundamental investment strategy, risk arbitragers also gather and evaluate any available information, and buy or sell based upon evaluation of the information obtained.

Risk arbitragers believe that through good research they can control risk arising from factors intrinsic to the control transaction, and earn returns commensurate with the amount of risk borne. Evaluating the viability of a control transaction is an intricate, multi-step process. The complexity of the information needed for the evaluation amplifies the professional trading advantages already present in hedging. Data must be gathered from publicly available documents, including SEC mandatory disclosure documents such as 10-Ks, proxy statements, and tender offer schedules.[51] Other public documents such as non-SEC regulatory filings or court records are examined. Like traditional securities professionals doing other types of fundamental analysis, risk arbitragers also do considerable independent research in addition to reviewing readily available public information.[52] Managers of the participating firms are contacted. Professionals, particularly lawyers, are employed by an arbitrager to gather new information. Corporate counsel may be used to attend court sessions in an attempt to ascertain whether a particular defensive tactic will be effective. Antitrust counsel may also be used to obtain information from various enforcement agencies. Similarly, an arbitrager may employ independent tax counsel to give advice on the tax issues. In this way, arbitragers create new information as to the likelihood of a successful deal.

The business sense of a proposed transaction is critical to the arbitrager's analysis of whether the transaction will be consummated. Arbitragers need information about the fundamentals of the deal, and the fundamentals of the firms to make this determination. Crazy deals fall apart. Thus, to decide whether a deal makes sense, the risk

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[51] I. BOESKY, *supra* note 3, at 62-63.

[52] For example, in the Gulf-Socal transaction, where proposed federal legislation could have stymied the deal, Boesky employed political consultants, economists and lawyers in an attempt to gather information and analyze whether passage was likely. Bruck, *supra* note 6, at 99.

arbitrager prepares pro forma balance sheets and income statements with an eye toward valuing the participating firms in a control transaction environment.[53] Arbitragers also make earnings projections and cash flow projections for the involved firms to determine whether the amount of debt created for the transaction can be carried. If the control transaction involves restructuring the target's lines of business, the arbitrager may attempt to determine the value of assets that are likely to be sold off. If projection data has not been disclosed, the arbitrager may attempt to obtain this information from the subject firms. Particularly for the largest transactions, uncertainty may exist as to whether financing will remain in place so that the deal can be closed. This uncertainty is increased if the economics of the transaction are not sound. Thus, arbitragers determine whether the deal makes economic sense for both the acquiring and acquired firm.

Other issues that may fundamentally affect the deal are also reviewed. In all types of transactions, friendly and hostile, the attitudes of existing management are key. The likelihood of competing offers or auctions as well as the possibility of a competing leveraged buyout or debt-financed restructuring should be considered.[54] When management is opposed, the available financial and structural defenses should be reviewed and analyzed.[55] Fair price and other supermajority charter provisions[56] might make it difficult for a raider to complete the transaction. The presence of poison pills and other rights plans are powerful defensive devices,[57] making the outcome of specific transactions unpredictable.[58] For example, the outcome of a particular deal

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[53] This data gives some indication as to whether competing offers are likely.

[54] *See* Gordon & Kornhauser, *Takeover Defense Tactics: A Comment on Two Models*, 96 YALE L.J. 295 (1986).

[55] *See generally* R. FERRARA, M. BROWN & J. HALL, TAKEOVERS: ATTACK AND SURVIVAL (1987). The authors discuss various defenses including shark repellants, poison pills, restructured voting rights, greenmail, defensive mergers, and stock lockups to guard against hostile takeover. The effect of these tactics on the deal is an area where the risk arbitrager produces new information as well as evaluates data in the public domain. Not only does the arbitrager attempt to collect information from the firms involved, but the arbitrager will often hire his own experts to evaluate the transaction.

[56] *See id.* at 321. A fair price provision requires supermajority approval for a merger unless the price paid by the acquiror to the minority shareholders equals or exceeds the highest price paid by the acquiror before the merger. *Id.* A supermajority charter provision is usually added to the certificate of incorporation in order to require a greater than majority rate to approve a merger or a sale of the assets. *Id.*

[57] *Id.* at 337. Poison pills and similar rights plans are attempts to raise the cost of the offer while diluting the voting power of an acquiror. Typically, the plan includes a distribution of special voting rights. Such plans can make the cost of a takeover prohibitive to the acquiror. *Id.*

[58] *See, e.g.*, Minstar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985) (enjoining AMF from using various defenses during a takeover bid).

may turn on a judgment of the Delaware courts as to whether target management should redeem the poison pill.[59] The new generation of state anti-takeover statutes which have increased the complexity of takeovers also must be considered.[60] As the effect of these factors on the deal changes, the risk arbitrager must constantly monitor his position and promptly modify his investment decision.

A common issue impacting control transactions is antitrust. Significant antitrust difficulties can delay or terminate a transaction, or determine which competing offer will succeed.[61] In some deals even a serious review by the Justice Department or FTC under the Hart-Scott-Rodino premerger notification process,[62] whether or not suit is brought, can create devastating delays.[63] In regulated industries such

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[59] *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding the target's use of a "poison pill" as a defensive weapon).

[60] Beginning in the late 1960s, state legislatures developed takeover legislation aimed at informing and protecting the minority shareholder. The Supreme Court in CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987), validated on constitutional grounds the Indiana statute which provides for a shareholder vote to grant voting rights to the acquiror, *id.* at 94, and limited the reach of Edgar v. Mite Corp., 457 U.S. 624 (1982), which held the Illinois first generation takeover statute unconstitutional on commerce clause and preemption grounds. *Id.* at 642-46. After *CTS*, the Delaware approach, regulating second-step transactions, also has been held constitutional. BNS Inc. v. Koppers Co., 683 F. Supp. 458 (D. Del. 1988); *see also* Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113-20 (1987) (discussing *Mite* and the need for takeover statutes); Note, *The Constitutionality of Second Generation Takeover Statutes*, 73 VA. L. REV. 203 (1987). For a summary of the remaining questions unresolved by *CTS*, see Junewicz & Quinn, *The Constitutional Issues that* CTS *Left Open*, in STATE TAKEOVER REGULATION TODAY 243 (ALI-ABA 1988). These post-*CTS*, statutes increased the uncertainty that a proposed transaction will be completed.

[61] *See, e.g.*, Marathon Oil Co. v. Mobil Corp., 669 F.2d 378 (6th Cir. 1981) (upholding lower court's entry of preliminary injunction enjoining oil company's takeover of another oil company), *cert. denied*, 455 U.S. 982 (1982); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.) (directors' decision to file antitrust suit in connection with hostile takeover falls within protection of the business judgment rule), *cert. denied*, 454 U.S. 1092 (1981).

[62] 16 C.F.R. Parts 801, 802 and 803 (1988). For a brief discussion of the pre-merger notification process, see R. FERRARA, M. BROWN & J. HALL, *supra* note 55, at 148.

[63] The recent buyout of RJR Nabisco shows that antitrust remains relevant to merger risk arbitrage. Kohlberg Kravis Roberts & Co., the buyers of RJR, also hold a substantial interest in Beatrice Foods. Several significant competitive overlaps existed between RJR and Beatrice. The FTC required spin-offs before the transaction could go forward. Reaching an agreement with the FTC reduced uncertainty concerning the merger. This reduced uncertainty was promptly reflected in the market price of RJR. *See* Smith & Waldman, *Buy-out of RJR Proceeds as Financing is Expanded, Antitrust Pact Is Reached*, Wall St. J., Jan. 31, 1989, at A-3, col. 2.

The operation of the premerger notification process can end a transaction even though an antitrust enforcement action is never brought. Also the process may favor one competing bidder over another. *See, e.g.*, *In re* J.P. Stevens & Co. Shareholders Litig., (West Point-Pepperell, Inc. v. J.P. Stevens & Co.), 542 A.2d 770, 773-76 (Del. Ch.) (competitor/bidder of company undergoing corporate auction lost bid due to antitrust concerns), *appeal denied*, 540 A.2d 1089 (Del. 1988). The antitrust enforcement agencies have been sensitive to these problems, but some significant impact is inevitable. In the competing offers for Conoco, the decision of the antitrust division to issue a second request to Mobil apparently played some role in defeating Mobil's as banking and insurance, the regulatory approval process for takeovers is daunting.[64] Transactions in these industries are time consuming and expensive. In these industries hostile deals have only recently become possible. A recently contested insurance takeover took eight months[65] while a contested bank takeover took eleven months.[66] Throughout this extended time period, a risk arbitrager would have to collect and evaluate information concerning whether regulatory approval was likely.

C. *The Benefits of Risk Arbitrage*

Empirical data suggest that the trading of risk arbitragers leads to an efficient market in deal stocks.[67] The spread accurately reflects the risk that a transaction will fail or that a competing higher offer may occur. Spreads are strongly correlated with eventual outcomes.[68] Thus, risk arbitrage activity is generally consistent with the efficient capital market theory.[69] Under the semistrong version of this theory, the trading of market participants, particularly informed market professionals, imparts all public and much private information to the market.[70] As a consequence, the stock market operates as an efficient valuer of firms.

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higher valued offer. Ruback, *The Conoco Takeover and Stockholder Returns*, 23 SLOAN MGMT. REV. 13 (1982).

[64] Lenn & Dowd, *Two Recent Takeover Attempts are Test Cases*, Nat'l L.J., Sept. 19, 1988, at 21, col. 1. In banking, the comprehensive regulating scheme of the Bank Holding Company Act of 1954, 12 U.S.C. §§ 1841-1850 (1982 & Supp. V 1987), and the Change in Bank Control Act of 1978, 12 U.S.C. § 1817(j) (1982 & Supp. V. 1987), reduce the risk of hostile bank takeovers. *See* Roche, Berkery & Hinman, *Hostile Takeover of Banks—Part I*, Nat'l L.J., Aug. 9, 1982, at 17, col. 1.

[65] *See* Lenn & Dowd, *supra* note 64 (discussing hostile insurance-related takeover of Farmers Group, Inc.).

[66] *See id.* (discussing hostile takeover of Irving Bank).

[67] Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 551 (1984).

[68] Brown & Raymond, *supra* note 5, at 54.

[69] The Efficient Capital Market Hypothesis (ECMH) is the widely accepted theory that the capital market responds efficiently to information. Gilson & Kraakman, *supra* note 67, at 554; *see* Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

[70] Professors Gilson and Kraakman explain the existence of the various forms of the efficient capital market theory as including Eugene Fama's weak, semistrong, and strong forms as a "device for classifying empirical *tests* of price behavior." Gilson & Kraakman, *supra* note 67, at 555-58 (citing Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970)) (emphasis in original); *see also* Note, *supra* note 69, at 1041-54 (discussing the ECMH in greater detail); Comment, *Should Tender Offer Arbitrage Be Regulated?* 1978 DUKE L.J. 1000, 1015-25 (discussing the ECMH in the risk arbitrage context).

The mechanisms of market efficiency lead to this result.[71] Risk arbitragers are efficient gatherers and evaluators of information, reducing the relative cost of data collection. The volume of risk arbitrage trading assures that the information will be communicated dynamically to the market through the price-signalling mechanism. Price movements signal the processing of new data and its impact on investors. A rapid new consensus judgment on value is reached as the market promptly reflects new information concerning the deal.[72]

The efficient market in deal stocks allows nonprofessional traders access to the information produced by risk arbitragers through the price-signalling mechanism and spreads the benefit of the search efforts of risk arbitragers.[73] Liquidity as well as information is created.[74] The investment decision for the nonprofessional trader is therefore much less complex. Moreover, because the search for costly information should reduce uncertainty, spreads are smaller as a result of arbitrager activity. The volatility of securities prices in the takeover market only reflects complex, changing conditions. However, risk arbitragers under the current regime seem to have sufficient incentive to collect costly information.[75] The trading of risk arbitragers creates market efficiency[76] and allows investors with low risk preferences ready access at low transaction costs to investors who are willing to bear a higher proportion of the deal risk, yet does not seem to result in supernormal profits for arbitragers.[77] Thus, risk arbitragers create considerable benefit.

D. *The Costs of Risk Arbitrage*

What, then, went wrong with the Boesky and related scandals?[78] Everything. Boesky used material, nonpublic information[79] to make

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[71] The notion of market mechanisms as a tool to analyze securities law questions is also derived from Gilson & Kraakman, *supra* note 67, at 642-43. The depth of the efficiency of the market is the product of both the cost of collecting information and the volume of trading controlled by trading investors with new information.

[72] The processing of information is dynamic. The volume of risk arbitrage trading imparts new information to the market, even if the precise data is not available to all investors.

[73] Dennis, *supra* note 16, at 416.

[74] I. BOESKY, *supra* note 3, at 19.

[75] Larker & Lys, *An Empirical Analysis of the Incentives to Engage in Costly Information Acquisition: The Case of Risk Arbitrage*, 18 J. FIN. ECON. 111, 112 (1987).

[76] *See* Poulsen *supra* note 7, at 478-91 (noting regulatory constraints on profits).

[77] I. BOESKY, *supra* note 3, at 19.

[78] A good summary of the various inside trading scandals is contained in the House committee report on the Insider Trading and Securities Fraud Enforcement Act of 1988. H.R. REP. NO. 910, 100th Cong., 2d Sess. 11-14, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6048-51 [hereinafter HOUSE REPORT].

[79] *See* Basic Inc. v. Levinson, 108 S. Ct. 978, 979 (1988); 3 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 7.4 (1986) (discussing materiality

investment decisions.[80] This information usually concerned the raider's decision to make an offer.[81] Boesky's conduct not only potentially disadvantaged shareholders of the target who sold early, but also could have harmed raiders.[82] Boesky's conduct may have raised the price of a target's stock sufficiently so that some raiders failed to make *any* offer. Over time, this would reduce the search for targets thereby reducing the value of firms across-the-board. Boesky and his colleagues also violated the rules requiring information about beneficial ownership of shares as well as the rules concerning margins and net capital.[83] These rules are intended to protect the informational and financial integrity or solvency of the market. Misleading disclosure resulting from a violation of these rules confounds the price-signalling

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in inside trading).

[80] SEC v. Boesky, SEC Litigation Release No. 11,288 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991 (S.D.N.Y. Nov 14, 1986). The effect of Boesky-type conduct is made clear by using the example provided previously. *See supra* text accompanying notes 37-38. An arbitrager trading on material, nonpublic information would acquire the stock of the target firm before the announcement of the offer at the then-current market price of $50 per share, rather than the post-announcement price of $58 per share. As a result of this illegal trading, the selling shareholders have in some sense "lost" the $8 profit from the announcement of the tender offer, and the arbitrager will be weighing a potential $10 profit against a potential $2 profit, thereby greatly reducing the risk of any loss, and as in this example, potentially profiting whether or not the underlying transaction is consummated.

[81] *See Boesky*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991, at 94,857.

[82] FMC Corp. v. Boesky, 673 F. Supp., 242 (N.D. Ill. 1987), *rev'd*, 852 F.2d 981 (7th Cir. 1988), demonstrates the potential harm which may result from Boesky-type conduct. In *FMC*, the corporation sought to recapitalize thereby reducing the shareholders' equity. *Id.* at 243. Goldman Sachs initially issued a fairness opinion at $80 per share; however, Levine tipped Boesky concerning FMC's plan and Boesky heavily purchased FMC stock. This in turn drove up the price. *Id.* at 244. Although FMC ultimately closed the transaction, FMC claimed it paid $220 million more for the stocks and experienced higher borrowing. *Id.* at 245. The *FMC* action was brought by the corporation which sought to recover $235 million in actual damages and Boesky's profits from his illegal trading, as well as RICO treble damages. *Id.* at 245-46. Another such case is Litton Indus. v. Lehman Brothers Kuhn Loeb, Inc., 709 F. Supp. 438 (S.D.N.Y. 1989). Therer the court held that, as a matter of fact, the illegal insider trading was not causally linked to any loss of the offeror under 10(b). The court also held that the offeror lacked standing to sue under 14(e).

[83] Rule 13d requires a person who beneficially owns more than 5 percent of a class of equity security to disclose their plan or intentions relating to the issuer/source and the amount of financing within 10 days. 17 C.F.R. § 240.13d-1(a) (1988). *See, e.g.*, Pantry Pride, Inc. v. Rooney, 598 F. Supp. 891, 899-900 (S.D.N.Y. 1984) (discussing the application of rule 13d). Boesky was indicted for a 13d disclosure violation relating to Fishbach Corporation holdings because he failed to disclose his agreement to park this stock for another beneficial owner. *See* Rath, *Developments in the Regulation of Securities Markets*, in INSIDER TRADING, COUNSELING THE BOARD, MERGERS AND ACQUISITIONS, MARKET REGULATION, 19 INST. ON SEC. REG., 325, at 327-31 (1988). Additionally, Boesky, in conjunction with Boyd Jeffries, secretly arranged for Jeffries to hold Seemala Corp. securities, thereby allowing Seemala, Boesky's broker-dealer, to violate the net capital limitations. *Id.* at 332. Kidder Peabody was also involved in parking securities, in buying stock on behalf of Boesky, and in extending him credit beyond the 50% margin limits. *Id.*

mechanism. These violations could threaten not only the financial standing of the arbitrager, but also raise the specter of cascading difficulties throughout the financial markets.

The regulatory structures which affect risk arbitrage activities are designed to protect market integrity. Although Boesky and other risk arbitragers violated these regulations, it is appropriate to analyze whether any of the illegal activity was necessary to allow legitimate efficiency conduct to go forward.

II. Regulation of Risk Arbitrage

A. *Inside Trading and Risk Arbitrage*

The most significant securities law violation alleged in the Boesky and related scandals involved claims of inside trading.[84] Reality turned out to be more colorful than the fictional inside trading depicted in the movies *Wall Street*[85] and *The Big Chill*.[86] An anonymous tip from a Merrill Lynch broker in Caracas concerning suspicious trading in deal stocks led to Dennis Levine, an investment banker with Drexel Burnham Lambert. Levine had served in the merger and acquisition departments of several investment banks. As it turned out, Levine was at the center of an inside trading ring.[87] Caught, Levine told his tale to the government.[88]

Levine used confidential nonpublic information obtained from his firm to trade in deal securities, and he recruited a number of tipsters to obtain additional inside information on proposed deals.[89] His in-

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[84] *See supra* notes 1-2.

[85] *Wall Street* (20th Century Fox 1987).

[86] *The Big Chill* (Columbia 1983).

[87] *In re* Boesky Sec. Litig. (Arden Way Assocs. v. Boesky), 669 F. Supp. 659, 660 (S.D.N.Y. 1987); Daugherty, *Insider Trading Charges Controversial*, N.Y.L.J., Dec. 8, 1986, at 33, col. 5.

[88] *Boesky*, 669 F. Supp. at 660. The SEC complaint filed against Levine alleged illegal trading in at least 54 companies while possessing material nonpublic information. Daugherty, *supra* note 87, at 33, col. 5. Levine pled guilty to four felony charges and agreed to a settlement with the SEC. Levine agreed to a permanent injunction against his participation in the securities industry and to fully cooperate with the government's continuing investigation. *See* SEC v. Levine, SEC Litigation Release No. 11,117 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,761 (S.D.N.Y. June 18, 1986); SEC v. Levine, SEC Litigation Release No. 11,095 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,717 (S.D.N.Y. May 21, 1986).

[89] Daugherty, *supra* note 87, at 43, col. 1.

formation almost exclusively related to the decision to enter into a control transaction, before that decision was publicly announced.[90] In six years of illegal trading, Levine profited to the tune of $12.6 million.[91] Levine surrendered these profits[92] and agreed to cooperate in further investigations of inside trading.[93]

Levine's cooperation directly led to the unmasking of Ivan Boesky.[94] For several years Levine had tipped Boesky about impending deals.[95] At first he gave the tips to cultivate a relationship.[96] Later, Boesky agreed to compensate Levine for the tips.[97] The core of the illegal activity was Boesky's trading on knowledge of control transactions before the transactions were publicly announced.[98] Boesky also obtained similar material, nonpublic information from Martin Siegel, formerly an investment banker with Kidder Peabody.[99] Boesky paid substantial sums to Siegel for the tips.[100] In recently filed complaints and indictments,[101] the SEC and Department of Justice charged Drexel Burnham and several of its senior executives with numerous securities law violations, including providing Boesky with material nonpublic information for the purpose of trading and profit sharing with Drexel.[102]

The SEC based its inside trading enforcement actions arising out of risk arbitrage activities on violations of rules 10b-5[103] and 14e-3.[104] Its legal theories raise a number of issues: Is the misappropriation theory[105] under rule 10b-5 valid? What is the scope of the section

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[90] *Id.*

[91] *Levine*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,761, at 93,703.

[92] *Id.*

[93] *See In re* Boesky Sec. Litig. (Arden Way Assocs. v. Boesky), 669 F. Supp. 659, 660 (S.D.N.Y. 1987).

[94] *Id.*; *see also* Wise, *Levine, Siegel Denied Dismissal In Boesky Partnership Actions*: Pollack *Decision in Civil Litigation*, N.Y.L.J., Sept. 25, 1987 at 1, col. 4.

[95] *See Boesky*, 669 F. Supp. at 660.

[96] *Id.*

[97] *Id.*

[98] *See* SEC v. Boesky, SEC Litigation Release No. 11,288 [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,991, at 94,857 (S.D.N.Y. Nov. 14, 1986); Ferrara & Gordon, *Inside Traders Face Wave of Private Litigation*, Nat'l L.J., Sept. 19, 1987, at 25, col. 1.

[99] *Boesky Sec. Litig.*, 669 F. Supp. 659; Wise, *supra* note 94, at 3, col. 2; *see In re* Boesky Sec. Litig. (SEC v. Drexel Burnham Lambert Group, Inc.), 861 F.2d 1307 (2d Cir. 1988) (unsuccessfully seeking recusal of Judge Pollack).

[100] *See Boesky*, 669 F. Supp. at 660.

[101] United States v. Milken, Indictment No. 89 Ca. 41 (K6W) (S.D.N.Y.); *see* Sontag, *Parking Examined! The Securities Dragnet Widens*, Nat'l L.J., Dec. 21, 1987, at 1, col. 3; Ferrara & Gordon, *supra* note 98, at 25, col. 1.

[102] *An Institution's Turn*, Nat'l L.J., Sept. 19, 1988, at 12, col. 1 (discussing SEC's suit against Drexel Burnham).

[103] 17 C.F.R. § 240.10b-5 (1988); *see supra* note 14 (setting forth rule 10b-5).

[104] 17 C.F.R. § 240.14e-3 (1988); *see also supra* note 15 (setting forth rule 14e-3).

[105] As used in inside trading cases, misappropriation means the conversion of material,

10(b) and rule 10b-5 antitipping prohibitions?[106]

Assuming that the current Second Circuit standards remain in force,[107] the SEC must prove that whoever leaked the information misappropriated the data, and must also prove that the risk arbitrager, in using the information, participated in the source's breach of a fiduciary duty[108] to the owner of the data.[109] Under these standards, the Boesky and related inside trading violations of rule 10b-5 are clear.

The most serious question is whether the expanded scope of rule 14e-3,[110] as compared with section 10(b) and rule 10b-5, is statutorily authorized.[111] Assuming the validity of rule 14e-3, the Boesky violation

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nonpublic information which was obtained under an expectation of privacy but converted to personal use in the trading of securities. *See* SEC v. Materia, 745 F.2d 197 (2d Cir. 1984), *cert. denied,* 471 U.S. 1053 (1985); Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back,* 52 ALB. L. REV. 775 (1988).

The misappropriation theory has its roots in Chief Justice Burger's dissent in Chiarella v. United States, 445 U.S. 222, 243-44 (1980). United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *cert. denied,* 464 U.S. 863 (1983), however, was the first case decided on the misappropriation theory under section 10(b). The *Newman* court held that the theory could be used to support criminal charges against a trader-tipper who misused inside information relating to takeovers and mergers. *Id.* at 19. The theory was applied again in *Materia,* which involved facts similar to *Chiarella,* but held that an employee of a financial printer who traded on confidential inside information for personal gain violated rule 10b-5. 745 F.2d at 203. A divided Supreme Court affirmed the Second Circuit's application of the theory in United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd by equally divided vote,* 108 S. Ct. 316 (1987) (4-4 decision), in which a journalist traded with the benefit of information misappropriated from the Wall Street Journal. *See also* United States v. Chestman, 704 F. Supp. 451 (S.D.N.Y. 1989) (unsuccessfully challenging the misappropriation theory as "invalid as a matter of law"). The securities law interest is more attenuated in *Carpenter* than it is in the risk arbitrage situation.

[106] Tipping occurs when the insider/tipper does not himself trade, but rather provides the inside information to an outsider/tippee who does trade.

[107] *See* Carpenter v. United States, 108 S. Ct. 316 (1987) (4-4 decision) (upholding the Second Circuit's application of the misappropriation theory on an equally divided vote).

[108] *See Chiarella,* 445 U.S. at 227-29 (discussing Cady, Roberts & Co., 40 S.E.C. 907 (1961)).

[109] *See Carpenter,* 108 S. Ct. at 321-22.

[110] 17 C.F.R. § 240.14e-3 (1988). Rule 14e-3 prohibits trading on the basis of material, nonpublic information in connection with a tender offer. Violation of rule 14e-3 is neither dependent upon misappropriation nor a breach of fiduciary duty with respect to a tipping situation. The rule is broader than the rule established in Dirks v. SEC, 463 U.S. 646 (1983), with respect to tipping. In *Dirks,* the court limited tippee liability to occasions when the inside information has been made available in an improper manner. *Id.* at 660. The disclosure is improper if the insider/tipper has breached a fiduciary duty to the corporation or its shareholders.

In contrast, rule 14e-3 imposes liability on a tippee merely for trading on information that he knows or has reason to know was obtained from an insider. *See supra* note 15 and *infra* note 180 (setting forth the relevant langauge of 14e-3). A breach of fiduciary duty by the insider/tipper need not occur to trigger the application of rule 14e-3. *See* D. LANGEVOORT, *supra* note 2, at 21 (discussing the broader reach of rule 14e-3).

[111] The langauge contained in Rule 14e-3 is similar to that in rule 10b-5. *See* United States v. Chestman, 704 F. Supp. 451 (S.D.N.Y. 1989). A violation of rule 10b-5 requires a culpable

is clear. The more difficult question is whether legitimate risk arbitrage activity would be illegal under these standards.

The leading section 10(b) Supreme Court case on inside trading involving control transactions is *Chiarella v. United States*.[112] Chiarella was a financial printer for Pandick Press. In connection with his job, Chiarella prepared tender offer documents.[113] Chiarella was able to decode the identity of targets from the drafts he reviewed.[114] Before a tender offer was publicly announced, Chiarella purchased the target's stock. He then sold on the post-announcement price run-up, profiting approximately $30,000 over a fourteen-month period.[115] As a result, Chiarella was convicted of a criminal violation of section 10(b) and rule 10b-5.[116]

When *Chiarella* reached the Supreme Court, a majority of the justices construed the indictment as only charging Chiarella, as a market insider, with a violation based upon a breach of duty to the shareholders of the target corporation.[117] In cases involving "horizontal" inside trading,[118] Justice Powell wrote that "mere possession of nonpublic market information" does not create a duty to refrain from trading.[119] Reversing the conviction, the majority held that no

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mental state, *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), which is not required for a 14e-3 violation. *See Chestman*, 704 F. Supp. 451 (unsuccessfully asserting that charges brought under rule 14e-3 should be dismissed because the SEC exceeded its authority in adopting the rule); 3 A. BROMBERG & L. LOWENFELS, *supra* note 79, § 6.3 (210)-(250).

[112] 445 U.S. 222 (1980).

[113] United States v. Chiarella, 588 F.2d 1358, 1362 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

[114] *Id.* at 1363.

[115] *Id.*

[116] *Id.* at 1364.

[117] *Chiarella*, 445 U.S. at 232-33.

[118] Generally inside trading schemes may be categorized into two basic models: horizontal and vertical trading. Conventional inside trading is vertical. Vertical inside trading occurs when a "true insider"—a director, executive officer, manager or employee of the corporation—purchases or sells securities of the employing firm. *See, e.g.*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (officers and employees of Texas Gulf Sulphur bought shares of the corporation based upon nonpublic information), *cert. denied*, 394 U.S. 976 (1969); *see also* Note, Dirks v. SEC's *Footnote Fourteen: Horizontal and Vertical Reach*, 62 WASH. U.L.Q. 477, 494-99 (1984) (discussing the scope of "vertical" fiduciary duties).

Inside trading involving arbitragers tends to be horizontal. Horizontal insiders are those who are not "true insiders," but "have by virtue of their status unusual access to material nonpublic information relating to securities." D. LANGEVOORT, *supra* note 2, at 369. These "insiders" obtain, directly or derivatively, information from the acquiring firm affecting the value of a firm to be acquired. Of course, if the material, nonpublic information concerning a control transaction came from the company whose stock was being traded—for example trading in advance of announcement of a leveraged buyout, self-tender, or market repurchase program—conventional notions of inside trading apply. Under conventional notions of insider trading, a fiduciary relationship would exist. Therefore, reference to other theories of liability, such as misappropriation, is unnecessary.

[119] *Chiarella*, 445 U.S. at 235.

such duty existed.[120] The majority stated "not every instance of financial unfairness constitutes fraudulent activity under § 10(b)."[121] Merely being in possession of material market information[122] does not place one in the status of an insider.[123] Rather, when the action is based upon nondisclosure, the duty to speak only "arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.' "[124] But Chiarella "was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions."[125] Because Chiarella received no confidential information from

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[120] *Id.* at 231-33. The Court refused to adopt the district court's formulation which had been affirmed by the court of appeals. The district court's jury instruction defined a duty to disclose as a duty owed to all traders in the market. *Id.* at 231. The majority noted that "[t]he Court of Appeals, like the trial court, failed to identify a relationship between petitioner and the sellers that could give rise to a duty." *Id.* at 231-32. The indictment under section 10(b) was interpreted by the majority as requiring a finding of a duty of the insider to the specific shareholders of the target company to disclose nonpublic information before trading, rather than a duty to everyone. *Id.* at 232. Hence, the indictment required the finding that Chiarella had a duty to the target shareholders to disclose before trading. *See* Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement,* 70 CALIF. L. REV. 1, 11-39 (1982).

[121] *Chiarella,* 445 U.S. at 232. The Court also was concerned that notions of fair notice precluded an expansive reading of the inside trading prohibition, particularly in a criminal action. *Id.* at 237 n.21. Explicit notice is, however, given in situations covered by rule 14e-3.

[122] "Market information" is any information which has an influence on the market price of a particular security, but has no effect on the profitability or earning power of the company. Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information,* 121 U. PA. L. REV. 798, 799 (1973).

[123] *Chiarella,* 445 U.S. at 235. In this context "insider" refers to those who have been deemed to have a duty to disclose before trading. "Market insiders," however, do not necessarily owe a fiduciary duty to selling shareholders. *Id.* at 231-32 n.14. It must first be shown that there exists a "relationship between the parties [market insider and selling shareholders] . . . and not merely from one's ability to acquire information because of his position in the market." *Id.* Thus the Court rejected the Second Circuit view that the "regular access to market information" test was sufficient to find liability for the market insider. *Id.* at 231-35.

A "market insider" is a person, other than an offeror, with regular access to nonpublic information as a consequence of his relationship to the market. United States v. Chiarella, 588 F.2d 1358, 1366 (2d Cir. 1978). "Market insiders" differ from "true insiders." True insiders owe a fiduciary duty to shareholders of the corporation for which they are employed. *See Chiarella,* 445 U.S. at 227-29 (discussing Cady, Roberts & Co., 40 S.E.C. 907 (1961)). This duty is said to be pre-existing, resulting in an almost "per se duty to disclose" before trading. *See* D. LANGEVOORT, *supra* note 2, at 43-44. But the *Chiarella* majority "did not strictly limit its rationale to *pre-existing* fiduciary relationships." *Id.* at 57.

[124] *Chiarella,* 445 U.S. at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). This relationship of trust arises out of the employment relationship. *Id.* Other relationships, such as the investment banker-client, or lawyer-client relationship, create the same relationship of trust that gives rise to the concept of "temporary insider." D. LANGEVOORT, *supra* note 2, at 90. These temporary insiders have the same duties as employee insiders because "they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

[125] *Chiarella,* 445 U.S. at 232-33.

the target companies, the Court held, there was no such relationship of trust and no duty to disclose before trading.[126]

Part of the rationale for the Court's holding appears to be its notion that the prohibition against inside trading is not primarily directed at the effect on the disadvantaged trading shareholder as such, but rather at a problem of principal-agent relationships.[127] The principal—the corporation, and derivatively, its shareholders—has a property right in the use of the corporation's information.[128] Premature trading threatens that property right. The rule against inside trading as articulated in *Chiarella* coupled with the *Newman* line of cases encourages insiders to use information only for corporate purposes, not for individual gain.[129] Shareholders are the proper private plaintiffs in inside trading cases only because of the purchaser-seller rule. The real injured party, the corporation whose information is misappropriated, from a policy perspective should also have a claim.

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[126] *Id.* As Professor Langevoort suggests, the majority took a narrow view of the development of the common law affirmative duty to speak. D. LANGEVOORT, *supra* note 2, at 64. Under state law, a number of courts require disclosure when one party has exclusive access to information and the other party could reasonably expect disclosure of basic transaction facts. *Id.* at 56 n.46. This expanded affirmative duty might be particularly strong when no legal mechanism exists allowing the disadvantaged party to compete away its lack of information. Professor Langevoort cites the Restatement of Torts which states:

> One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated . . . (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

RESTATEMENT (SECOND) OF TORTS § 551(2)(e)(1976). This parity of information approach is reflected in Justice Blackmun's dissent in *Chiarella*. 445 U.S. at 247-48 (Blackmun, J., dissenting).

[127] Justice Powell wrote that the "[a]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information." *Chiarella*, 445 U.S. at 230.

[128] Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 27-28 (1984). Professor Macey concluded:

> The right to prohibit another from trading on the basis of inside information must stem from a notion that information is a form of property interest. The Court's opinion presupposes that the information Chiarella used was a property interest, and that interest gave Pandick the right to prohibit Chiarella from trading. Otherwise, Chiarella's trading would not have violated any preexisting duties. The majority opinion in *Chiarella* is thus entirely consistent with a business property theory of insider trading liability.

Id. (footnote omitted). Professor Macey further concluded that United States v. Newman, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983), put to rest any doubt that the *Chiarella* decision was based on a property theory. Macey, *supra*, at 27 n.96.

[129] For the *Chiarella* approach to apply, the Court requires something like privity between the owner of the information and the trader. The misused information must relate to the company and it must be that company's securities which are being traded before a duty to the corporation or its shareholders arises. Of course, subsequent developments expanded this duty.

Applying only the *Chiarella* rationale to the Boesky scandal demonstrates that such a market-insider approach to inside trading is insufficient to reach questionable risk arbitrage activities. Despite Levine's and Siegel's quasi-employee relationship with the acquirors in the Boesky scandal, their conduct may be equated to Chiarella's conduct from the perspective that they also did not have a relationship with the target companies involved. Thus, under *Chiarella*, absent a trust relationship with the target, Levine and Siegel had no duty to disclose, and their conduct would have been legal. Boesky himself could not be reached by the *Chiarella* approach to 10(b) because Boesky also had no preexisting relationship with the targets or their shareholders.

Unfortunately for Boesky, the courts, in subsequent litigation under section 10(b) and rule 10b-5, provided an alternative basis for liability. Two Second Circuit cases, *United States v. Newman*[130] and *SEC v. Materia*,[131] adopted the misappropriation theory of inside trading in the context of control transactions.[132] The misappropriation theory views the principal-agent aspect of the inside trading violation from the perspective of the raider rather than the target shareholders. *Chiarella* had left open whether misappropriating the confidential information of the raider in connection with trading in securities of the target violates rule 10b-5.[133] These two cases, relying on *Superintendent of Insurance v. Bankers Life and Casualty Co.*,[134] explicitly held that section 10(b) fraud can occur even if the fraud is not directed at the purchaser or seller of securities.[135] The Second Circuit

[130] 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983). In *Newman*, the Second Circuit did not consider whether the trading also violated rule 14e-3 because the conduct occurred before that rule was adopted.

[131] 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985).

[132] A third Second Circuit case, United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 108 S. Ct. 316 (1987) (4-4 decision), takes the misappropriation theory one step further. In *Carpenter*, the fraud involved trading on the advance knowledge of stories appearing in the Wall Street Journal. *Id.* at 1026-27. The behavior violated a Journal policy and allegedly posed potential harm to the public's perception of the integrity of the Journal. *Id.* at 1027. This interest is further removed from the securities law interests implicated in the control transaction circumstance.

[133] Chiarella v. United States, 445 U.S. 222, 237 n.21 (1980).

[134] 404 U.S. 6 (1971). In *Bankers Life*, the Supreme Court held the "in connection with" language of section 10(b) can be satisfied if the deceptive practice only touches upon the purchase or sale of any securities. *Id.* at 12-13.

[135] *Newman*, 664 F.2d at 19; *Materia*, 745 F.2d at 201; *see* D. LANGEVOORT, *supra* note 2, at 204. Justice Stevens concurring opinion in *Chiarella* is particularly concerned with this point. *See* 445 U.S. at 238 (Stevens, J., concurring). By citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), as perhaps a bar to the misappropriation theory, Justice Stevens appears to be concerned that the securities laws may not be intended to protect the fiduciary relationship between employer and employee, but rather the breach of fiduciary duty may have

reasoned that the "in connection with" language in the statute and rule is satisfied by the knowing use of purloined information to purchase or sell, particularly when the fraud against the raider impacts some value that the securities laws are intended to protect.[136]

In the tender offer context, the misuse of the offeror's confidential information impacts upon its ability to complete securities transactions by making the bid potentially more costly.[137] The *Newman* court suggested that horizontal inside trading potentially harms the raider "whose takeover plans . . . [are] keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information."[138]

With respect to the raider/quasi-employee relationship, misappropriating an employer's information might be perceived as only a breach of fiduciary duty, akin to mere internal corporate mismanagement.[139] In the context of illegal pre-announcement risk arbitrage, however, something more is involved—a potential distortion of the raider's investment decision directly linked to the questioned trading.

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to be closely connected with an actor participating in a related securities transaction. Whether this was a valid concern, or whether securities laws were, in fact, intended to protect fiduciary duties between employer and employee also was left as an open issue. 445 U.S. at 238 (Stevens, J., concurring).

[136] *Newman*, 664 F.2d at 18; *Materia*, 745 F.2d at 203. This is a narrower version of the misappropriation theory than that articulated by Chief Justice Burger in *Chiarella*, 445 U.S. at 243 n.4 (Burger, C.J., dissenting). The Chief Justice would have found liability even if no fraud had been committed against the source of the information. There need only be misappropriation. *Id.*

Another variation on the misappropriation theory is stated by Professor Aldave. Aldave, *Misappropriation: A General Theory for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 100 (1984). Professor Aldave suggests unidentified shareholders of the target are injured as a consequence of the theft from the raider.

[137] Another value the Second Circuit intends to protect is the investment banker employer's interest in being viewed as an efficient keeper of client secrets. *Newman*, 664 F.2d at 15-16. It is difficult to see how this value is one that the securities laws are intended to protect.

[138] *Id.* at 17.

[139] *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977). In *Santa Fe*, the majority shareholder corporation, Santa Fe Industries, wished to acquire the remaining outstanding shares of its subsidiary, Kirby Lumber, by a tender offer. *Id.* at 465. Santa Fe offered the minority shareholders a $25 premium per share on the independently appraised market value of the outstanding shares, or $150 per share. *Id.* at 466. The minority shareholders brought an action under rule 10b-5, claiming that Kirby shares were worth $772 per share on the fair market value of the company's physical assets. They claimed that Santa Fe was freezing them out based upon a fraudulent appraisal at $125. *Id.* at 467. The district court dismissed the action, reasoning that rule 10b-5 did not prohibit offers which would eliminate minority shareholders when disclosure of the facts had been made. Green v. Santa Fe Indus., Inc., 391 F. Supp. 849, 854 (S.D.N.Y. 1975), *aff'd in part, rev'd in part,* 533 F.2d 1283 (2d Cir. 1976), *rev'd,* 430 U.S. 462 (1977). The Second Circuit reversed, in part, ruling that a breach of fiduciary duty by majority shareholders could satisfy a claim based upon rule 10b-5 even without a claim of misrepresentation or non-disclosure. Green v. Santa Fe Indus., Inc., 533 F.2d 1283, 1286-87 (2d Cir. 1976). The Supreme Court reversed.

The Second Circuit's misappropriation theory is consonant with legitimate risk arbitrage.[140] Under the securities laws, the creator of the information concerning the value of the target should be protected.[141] The discovery value of information is what encourages its production in the first instance. Information is generally a public good, but inside information is in part used up by the disloyal agent's trading. Misuse of the information raises the substantial risk of transferring that value from raider to outsider, thus reducing the search for targets, and consequently reducing production of the value-enhancing information. By discouraging misuse, shareholders of both raiders and targets will benefit.[142] Considered in this light, a risk arbitrager has no legitimate claim to the uncompensated nonconsensual use of the property produced by the raider.

A second-step is required in order to determine whether application of the misappropriation theory would extend section 10(b) and rule 10b-5 to reach the questionable risk arbitrage activities of Boesky. This step requires determining whether the arbitrager as a tippee of a misappropriator is equally prohibited from trading. The leading case on trading by tippees is *Dirks v. SEC*.[143] Dirks received a tip from an Equity Funding of America insider concerning an undoubtedly material and nonpublic massive fraud within Equity Funding.[144] Dirks, in turn, passed on that information to selected clients who traded on the information.[145] Yet the Supreme Court held that Dirks was not liable for illegal inside trading.[146] As in *Chiarella*, Dirks, as an

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[140] This analysis is consistent with the current regulatory pattern allowing a potential raider to purchase up to five percent of the securities of a potential target without disclosing under the requirements of section 13(d) of the Williams Act. Williams Act § 13(d), 15 U.S.C. § 78m(d) (1982 & Supp. V 1987). Allowing secrecy protects part of the raider's investment in creating and gathering information about the target in order to find prospective deals. The raider's discovery value interest is noted in *Chiarella*, 445 U.S. 222, 242 (1980) (Burger, C.J., dissenting); *see also* Macey, *supra* note 128, at 29 & n.99 (discussing the requirements of a tender offer and further supporting the misappropriation theory as a basis for liability in *Chiarella*).

[141] Macey, *supra* note 128, at 28.

[142] The gain to raider shareholders is apparent. The gain from the discovery value will be dissipated if shared with the market through the trades of the misappropriator. Macey, *supra* note 128, at 27 & n.95. The shareholders of the target are also injured because *ex ante* they gain with a securities law structure which enhances the incentives to search for hidden values about their firm.

[143] 463 U.S. 646 (1983).

[144] *Id.* at 649.

[145] *Id.* Neither Dirks nor his firm owned or traded in Equity Funding securities, but Dirks advised customers concerning the fraud. *Id.* The convention in the industry is that compensation for information like that given by Dirks to his customers is provided by directing trades through the tippee's firm. *Id.* at 649 n.2. After Dirks informed his customers of the fraud, several did trade through Dirks' firm. *Id.*

[146] *Id.* at 667.

outsider, owed no pre-existing duty to Equity Funding shareholders.[147] The Court held that liability as a tippee turns on liability of the tipper.[148] Because the employee-tipper in *Dirks* received no pecuniary gain or other personal benefit from the tip, he breached no fiduciary duty to the shareholders of Equity Funding.[149] Consequently, Dirks was not "a participant after the fact,"[150] and he was free from the constraints of the disclose-or-abstain rule.[151]

The gain to the inside tipper that would trigger the disclose-or-abstain rule can come from four sources: (1) tips that are paid for in cash; (2) tips in exchange for information—quid pro quo tips; (3) a gift of confidential information by an insider to a trading relative or friend, which the courts will equate to trading by the insider followed by a gift of the proceeds to the tippee; and (4) tips leading to "a reputational benefit that will translate into future earnings" or other economic benefit.[152]

Underlying the *Dirks* opinion is a coherent economic rationale for the insider trading rules. Two aspects of the policy are explicit while one aspect is implicit. Implicit in the Court's approach is the notion that property rights in information are a cornerstone of inside trading law.[153] Explicit in the Court's approach are the notions that monitoring

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[147] *Id.* at 665.

[148] *Id.* at 660-61 (citing *In re* Investors Mgmt. Co., 44 S.E.C. 633, 660 n.19 (1971) (Smith, Comm'r, concurring)). The Court stated that "tippee liability properly is imposed only in circumstances where the tippee knows, or has reason to know, that the insider has improperly disclosed inside corporate information." *Id.*

[149] *Id.* at 665. Use of material, nonpublic information is only improper if the insider uses it for his own gain. Therefore, a tippee is only liable if the tipper profits from the disclosure to the tippee. *Id.* at 662 (citing Cady, Roberts & Co., 40 S.E.C. 907, 912 n.15 (1961)); *see infra* note 152 and accompanying text (discussing tipper profit and gain).

[150] *Id.* at 667 (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980)).

[151] *Id.* at 655.

[152] *See id.* at 663-64 (citing Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 332, 348 (1979)); *see also* D. LANGEVOORT, *supra* note 2, at 130-32 (discussing three types of benefits accrued by an insider that will satisfy the *Dirks* test). It might be argued that the tipper in *Dirks* was trying to obtain a benefit in the form of a reputational gain. *See* Macey, *supra* note 128, at 37-38 & n.144. To the extent that the concept of reputational gain is expansive but as yet not clearly defined, the *Dirks* safe harbor for tippee liability is reduced.

The issue of gain is a question of fact, *Dirks*, 459 U.S. at 664, to be examined in light of "objective criteria," *id.* at 663. One commentator has suggested "revenge" as a possible personal benefit. *See* Macey, *supra* note 128, at 38 n.144.

[153] The facts of *Dirks* could form the basis for an alternative holding that information concerning the presence of a fraud is not the kind of information that creates any property right for the employing firm of the tipper. Macey, *supra* note 128, at 39-41; *see also* Fischel, *Insider Trading and Investment Analysts: An Economic Analysis of* Dirks v. Securities Exchange Commission, 13 HOFSTRA L. REV. 127 (1984). Professor Fischel argues that the specific information in *Dirks*

agents' use of information is needed and that legitimate informational needs of securities professionals should be protected.[154]

The Court's opinion shows considerable sophistication concerning securities professionals and an appreciation for the benefits to the market created by securities professionals. *Dirks* diminishes the legal risk an analyst faces when obtaining information from an insider. The material, nonpublic nature of the information concerning a massive hidden fraud given to the analyst in *Dirks* was atypical.[155] The Court noted that in the typical case the analyst will not be required to make difficult judgments concerning whether information received from insiders is sufficiently public or whether it is material.[156] Rather the inquiry can be limited to a determination of whether the insider is obtaining a prohibited gain.[157]

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would be the type shareholders would *ex ante* wish to be disclosed. *Id.* at 139.

Criticizing the *Dirks* rule, Professor Macey suggests that the proper exclusive test to determine if tipping should be legal is whether use of the tipped information could properly be considered as the subject of a contract between the employer and the tipper. Macey, *supra* note 128, at 39-41. Professor Macey's criticism of the *Dirks* rule seems to undervalue the significance of an agency cost perspective as well as the post-*Chiarella* development holding quasi-insiders liable as misappropriators.

Professor Fischel suggests the effect a tipping rule would have on analysts is a significant factor to determine the proper scope of tipping rules. Fischel, *supra*, at 144-45. But Professor Fischel argues that the pecuniary gain test is irrelevant in determining whether tipping is legal. *Id.* at 139. As the following discussion demonstrates, a major benefit of the pecuniary gain test is that it allows efficient tipping and reduces agency costs.

[154] *Dirks*, 463 U.S. at 658-59.

[155] *Id.* at 658 n.18.

[156] *Id.* at 658-59. Furthermore, in the typical case, due to the nature of the information provided to the analyst, disclosure to the public simultaneously with disclosure to the analyst generally cannot be done. *Id.* at 659.

An example of the complexity of such an inquiry in the analyst context is SEC v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977). Analysts collect information, including nonpublic information, from a wide variety of sources, including managers of issuers. The conclusions from reviewing this information, if released by the issuer, might well be material. Whether any of the nonpublic information provided by an issuer is in of itself material is a difficult question. The *Dirks* rule reduces the risks of liability for the analyst creating such a mosaic. 463 U.S. at 664 n.24. The Court expressly provided "a guiding principle for those whose daily activities must be limited and instructed by the SEC's insider-trading rules." *Id.* at 664. The Court further stated that "[w]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous, as the facts of this case make plain." *Id.* at 664 n.24; *see* D. LANGEVOORT, *supra* note 2, at 123; *Definition of Insider Trading: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess., pt. 2, at 13-14 (1987) [hereinafter *Definition of Insider Trading*]; *Improper Activities in the Securities Industry: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987) [hereinafter *Hearings on Improper Activities*].

[157] Dennis, *supra* note 16, at 418. Professor Langevoort interprets Elkind v. Liggett & Myers, Inc., 635 F.2d 156 (2d Cir. 1980), a Second Circuit case decided after *Chiarella* but before *Dirks*, as holding a tipper liable even though the tip apparently was given solely for a corporate

Developing the legal rule concerning tipping by focusing on analysts demonstrates the Court's substantial sensitivity to the needs of the securities markets.[158] Securities analysts are the market actors largely responsible for creating market efficiency.[159] Securities analysts are a low cost method for firms to disclose information: analysts may receive data and indirectly communicate it to the market with less loss of privacy for the disclosing firm than would be caused by general dissemination.[160] Moreover, analysts use the information disclosed efficiently by spreading the use of the data over the analysis of several firms. Economies of scale in using information are realized. In addition to performing the role of efficient information conduits, analysts check the information divulged by the firm against other facts. Because analysts routinely use a wide variety of data sources they are comparatively advantaged in detecting fraudulent firm disclosure. This verifying function reduces information-gathering costs for all investors.[161] The price-signalling mechanism enables all investors to benefit from the evaluation and information-dissemination efforts of analysts.

Risk arbitragers provide the same benefits to investors as conventional analysts. Like analysts in the conventional investment situation, risk arbitragers act as conduits and verifiers.[162] Rather than trans-

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purpose. D. LANGEVOORT, *supra* note 2, at 320. The Second Circuit found a breach of fiduciary duty because one group of shareholders, clients of analysts, were favored over another group, the general shareholding public. *Elkind*, 635 F.2d at 168. According to Professor Langevoort, this approach is only consonant with *Dirks* if the tip is construed as akin to a gift. D. LANGEVOORT, *supra* note 2, at 322; *see also* Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1120-24 (1985) (supporting a market integrity theory). These arguments discount the value of using analysts as efficient information conduits.

[158] Dennis, *supra* note 16, at 418.

[159] *Id.* Professors Gilson and Kraakman explain that information filters into the market in a variety of ways with a range of dynamic efficiencies. Gilson & Kraakman, *supra* note 67, at 568-72. Some information such as Federal Reserve Board announcements or past prices of securities is so readily available at such a low cost that the market is perfectly efficient. Other data comes into the market less dynamically. But professionally controlled trading, such as trading by risk arbitragers, usually controls a critical volume of trading so that the price of a security promptly, although not as dynamically, reflects the information used by such market professionals. At another level, the information known by professional traders is indirectly communicated to the market as other traders decode the trading patterns of their competitors. This phenomenon is particularly strong in risk arbitrage because traders attempt to track the activities of other arbitragers. *Id.*

[160] Dennis, *supra* note 16, at 418-19.

[161] Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 411-15 (1984).

[162] *Id.* For example, an arbitrager can independently test data concerning a particular defensive tactic when a participant in the transaction gives information concerning strategy. The value of selectively releasing information to analysts in the prearbitrage situation presents a less compelling case for protection than when the information about the status of a deal is released

mitting information to the market through trades induced by their recommendations, risk arbitragers provide information to the market by the effect of their own trades on price.[163] The price-signalling mechanism enables investors to piggy-back on arbitragers' investments in information production without all of the attendant costs or risks. From this perspective, the *Dirks* rule makes the market for corporate control work more efficiently.[164] Arbitragers are able to collect information directly from firms with little legal risk. Information collected from the participants in a transaction is likely to be the most predictive and accurate and thus of the most benefit to risk arbitragers and the market as a whole. The ability to use firm-provided information is an inducement to undertake the activity.[165] The information so collected is promptly, albeit indirectly, transmitted to the market by arbitragers' trades.

Why then the pecuniary gain rule concerning inside trading?[166] An

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during the pendency of the offer. Whether there is a major gap in the current regulation leaving Boesky-type prearbitrage conduct controlled only by the misappropriation/pecuniary gain rules is an open question.

[163] *See* Dennis, *supra* note 16, at 419. In Gilson and Kraakman's model, notification by price signalling would represent a combination of professionally and derivatively informed trading. Gilson & Kraakman, *supra* note 67, at 569-79. Because of the degree of trading by risk arbitragers, these modes of reaching a new price equilibrium in the control transaction context are particularly strong. Whatever the dynamic delay associated with the price-signalling mechanism—as opposed to informed trading induced by a direct announcement by participants in a transaction—the dynamic delay should be tolerated in order to induce the investment in producing information and the arbitragers' willingness to bear the risk that a transaction will not close.

[164] Dennis, *supra* note 16, at 419.

[165] In contrast, the fairness argument is based on the idea that there is something inherently unfair about allowing insiders to profit from information to which the public-at-large does not have access. The fairness rationale underlies the disclose-or-abstain rule announced by the Commission in Cady, Roberts & Co., 40 S.E.C. 907 (1961). This rule has two elements:

> [F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. at 912 (footnote omitted); *see also* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (stating that rule 10b-5 "is based in policy on the justifiable expectation . . . that all investors trading . . . have relatively equal access to material information"), *cert. denied,* 394 U.S. 976 (1969). For a discussion of the fairness element in pre-*Chiarella* jurisprudence, see Brudney, *supra* note 152, at 338 (summarizing the fairness approach as an "effort . . . to deny the possessor an informational advantage in trading with other investors, more than to inform the latter about the state of the world in order to facilitate their investment decisions generally").

[166] A tip given by an insider who has received some value for it taints the tip and creates a duty in the tippee to disclose or abstain from trading on the basis of the tipped information. Dirks v. SEC, 463 U.S. 646, 663 (1983); *see supra* note 152 and accompanying text (discussing types of gains); *see also* Brudney, *supra* note 152, at 348 (maintaining that "the notion that the insider gains from releasing the information selectively rather than to the public at large, coupled with receipt of the information by one who is such a selected beneficiary taints the

agency monitoring view[167] coupled with the implicit notion of property rights in information explains the *Dirks* rationale.[168] A firm has a significant interest in how valuable information it owns is used. In the analyst or risk arbitrager context, when no compensation to the tipper occurs as a consequence of the tip the only incentive to release the information is the firm's, and thus the agent's inducement to disclose should be consistent with the firm's interest.[169] Because selective disclosure through arbitragers may be efficient, there is a community of interest among managers, arbitragers, and investors generally.[170] The pecuniary gain rule secures this community of in-

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recipient so that he should no more be entitled to use it in trading than was the donor" (footnote omitted)).

[167] The legal prohibitions against inside trading serve to reduce monitoring costs with respect to agents' use of corporate information. Agency costs are created when an agent of the firm acts on his personal interests, interests that diverge from those of the firm. Those costs are reduced by adopting monitoring mechanisms and counter-incentives. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308-09 (1976). The rules against inside trading act as counter incentives.

[168] Many commentators recognize that trading only when there is informational equality has costs—less search for information and consequently more mispriced securities—and thus the research and trading activities of securities professionals have benefits. *See, e.g.*, Easterbrook & Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985); *see also Cady, Roberts & Co.*, 40 S.E.C. at 912. But one typically made argument is that it is simply unfair for insiders or their tippees to benefit from access to superior information that was produced exclusively for corporate purposes. Several reasons support inside trading even when permission for use by the owner of the information is not explicitly given. For example, Professor Manne argued that such trading does not harm investors since it ultimately drives the price of the security in the right direction, H. MANNE, INSIDER TRADING AND THE STOCK MARKET 96-103 (1966), and that it provides an efficient form of managerial compensation, *id.* at 138-41. However, incentives for prompt disclosure seem to be maximized by the rule against inside trading. Moreover, compensation through the allowance of inside trading creates a significant agency monitoring problem and may create perverse incentives for managers with respect to making unduly risky firm investments. Gilson & Kraakman, *supra* note 67, at 632 n.221.

[169] Mandatory disclosure during control transactions is directed at significant marginal incentives for nondisclosure. Beyond mandatory disclosure, authorized release of information when the decision to release is undistorted by personal gain should fall within the business judgment rule under state law. The content and form of corporate communications raise all the same issues of subtle business judgment as do operational business decisions. So long as releasing information is not distorted by issues of personal gain, due deference to corporate managers seems appropriate. For other perspectives on corporate interest in the manager's use of information, see Cox, *Insider Trading and Contracting: A Critical Response to the "Chicago School,"* 1986 DUKE L.J. 628 (recognizing that a partial reason for the current regulatory scheme is to create incentives for timely disclosure); Garten, *Insider Trading in the Corporate Interest*, 1987 WIS. L. REV. 573 (explaining how the use of some nonpublic information by traders can be in the corporate interest).

[170] *See supra* notes 162-65 and accompanying text. Professor Langevoort argues that selective tipping remains illegal after *Dirks*. D. LANGEVOORT, *supra* note 2, at 132. He argues that firm-only motivated selective tipping results in some pecuniary, reputational, or other gift-oriented benefit to the corporation. *Id.* at 130-36. He asserts that the different treatment of various shareholders results in a breach of loyalty. *Id.* at 135-36. This author disagrees. In part our

terest. If the tipper were allowed to gain from the tip, significant doubts would be raised as to whether there was a corporate or individual purpose for the tip.[171] With pecuniary gain tips legal, investors would have to undertake increased monitoring of private disclosures by managers, thereby increasing agency monitoring costs. Thus, the *Dirks* pecuniary benefit rule is consistent with shareholders' interest in minimizing monitoring cost.[172] The Supreme Court's current approach is a rational compromise between a complete prohibition on trading on material, nonpublic information tipped by insiders, and a rule which allows secondary inside trading in a completely unimpeded manner.[173]

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disagreement is one of degree. Professor Langevoort believes there rarely will be a time when selective disclosure is justified by a claim that the only practicable means of disclosure was through a specific analyst. *Id.* at 135. He asserts that there must be a legitimate corporate purpose in both the end being pursued and the means of dissemination used. *Id.* My position is based upon the notion that often the mode of releasing particular kinds of information is a business decision which should be analyzed according to the business judgment rule. Professor Langevoort also implicitly seems to be arguing that gains from the release of corporate information should be spread across the shareholder body equally. *See id.* at 135-36. In control transactions, however, often the gain is not equally shared and in many instances shareholders *ex ante* may not prefer an equal gain sharing rule. *See* Easterbrook & Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698, 711-14 (1982).

[171] In State Teachers Retirement Bd. v. Fluor Corp., 576 F. Supp. 1116 (S.D.N.Y. 1983), plaintiff-pension fund brought suit alleging that defendant corporation failed to affirmatively disclose confidential, material inside information. The tipper was the corporation's manager of public relations. He tipped Winterflett, an investment analyst with Manufacturers Hanover, that the corporation was awarded a $1 billion contract to construct a plant in South Africa. *Id.* at 1117. The court suggested that the tipper may have had a mixed motive in that the tip would have benefited both the tipper and the tipper's corporation. *Id.* at 1121. The court denied the defendant's motion for summary judgment because it decided there was insufficient evidence for it to reach a conclusion as a matter of law regarding the tipper's motivation. By leaving the issue of the tipper's motivation to the jury, it is not clear whether the court was unsure that there was a dual motivation, thus leaving that factual question for the jury, or whether a dual motivation absolves the tipper—leaving the issue of liability for the jury. If the latter is true, this implies that a tip stemming from a permissible motivation will not shield the tipper from liability if that tip is also given for an impermissible reason. *Id.* at 1120-21.

[172] An objection to my position is that the pecuniary gain test would allow a tipper to give his corporation's information away without risk of federal securities liability. As a practical matter, such a case would be rare. If it did occur, state corporate law presumably would provide a remedy under a duty of care approach. *See* Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law,* 80 NW. U.L. REV. 1473, 1522 (1986) (warning that "[t]his kind of analysis carries with it the danger of distorting state law fiduciary duty concepts to achieve a federal purpose unrelated to the state law goals for which the duty concepts were developed").

[173] Professors Gilson and Kraakman suggest that inside trading is a relatively ineffective way of communicating information to the market. Gilson & Kraakman, *supra* note 67, at 630. Changes in supply of a particular security do not directly communicate information to the investment community, rather investors are derivatively informed through price or trade decoding, which "functions slowly and sometimes only sporadically." *Id.* at 630-31. Risk arbitragers do attempt to monitor each others' trades to decode whether a particular arbitrager has obtained

The doctrinal uncertainties in using section 10(b) and rule 10b-5 to prohibit horizontal inside trading has also led the SEC to attempt to prohibit this activity under the Williams Act.[174] In 1980, shortly after *Chiarella* was decided, the Commission adopted rule 14e-3.[175] This rule purposefully attempts to avoid the fiduciary duty analysis imposed under section 10(b) by *Chiarella* and *Dirks*.[176] The rule is triggered by an offeror taking substantial steps toward commencing a tender offer.[177] Once this threshold is crossed, the rule prohibits any person, other than the offeror, who is in possession of material, nonpublic information concerning the offer from dealing in the securities of the target[178] if the information came directly or indirectly

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unique information. In circumstances under which a risk arbitrager is tipped for a corporate purpose and not the individual gain of the tipper, the tip may be the only possible way the corporation is willing to communicate with the market. As measured against no disclosure, disclosure through inducing the trades of key arbitragers creates more accurately priced securities.

[174] Williams Act § 14(e), 15 U.S.C. § 78n(e) (1982).

[175] 17 C.F.R. § 240.14e-3 (1988). The rule was proposed in 1979 before *Chiarella* was decided. Tender Offers, 44 Fed. Reg. 9956 (Feb. 15, 1979), and was adopted after *Chiarella*, Tender Offers, 45 Fed. Reg. 60,410 (Sept. 12, 1980). The Commission regarded the rule as necessary to fill a gap created by *Chiarella* and argued that its section 14(e) authority was not circumscribed by that case. *Id.* at 60,411 to 60,412.

[176] Despite the similarity between section 14(e)/rule 14e-3, and section 10(b)/rule 10b-5, liability may be imposed under 14e-3 without a breach of a fiduciary duty or a gain to the tipper. *See* 3 A. BROMBERG & L. LOWENFELS, *supra* note 79, § 7.5(531); *see also supra* notes 14-15 (setting forth the pertinent language of the rules).

[177] 17 C.F.R. § 240.14e-3(a) (1988). The statement of the basis for and purpose of adopting the rule describes the substantial step test broadly. *See* Tender Offers, 45 Fed. Reg. 60,410, 60,413 n.33 (Sept. 12, 1980). As a matter of statutory authority, it is arguable that the rule only attaches once a tender offer has commenced, rather than in the period before formal announcement. *See* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). The *Panter* court held that reliance on a misrepresentation is a necessary element of section 14(e) liability, and because the tender offer involved was withdrawn before the plaintiffs had an opportunity to accept or reject it, there was no such reliance, hence no liability. Under this construction of section 14(e), much of the conduct involved in the Boesky scandal would be outside the reach of the rule because the tipped information was given before the offers were commenced.

Two courts have rejected attacks on the rule on this basis: SEC v. Gaspar, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,004, at 90,979 to 90,980 (S.D.N.Y. 1985) (finding that prior decisions "clearly establishe[d] that § 14(e) is applicable in the absence of an actual tender offer" (citing Applied Digital Data Sys. v. Milgo Elec. Corp., 425 F. Supp. 1145, 1151-56 (S.D.N.Y. 1977); ICM Realty v. Cabot & Forbes Land Trust, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,585 (S.D.N.Y. June 6, 1974))); O'Connor & Assocs. v. Dean Witter Reynolds, Inc., 529 F. Supp. 1179, 1190 (S.D.N.Y. 1981).

When no tender offer has been made, there is no liability under section 14(e) even when directors made false statements of material facts. Lewis v. McGraw, 619 F.2d 192, 193 (2d Cir.), *cert. denied*, 449 U.S. 951 (1980).

[178] There are three exceptions to this prohibition. The rule provides that when an entity is making the trade, no liability will attach if the individual making the investment decision for the entity did not know the material inside information and the entity had adopted control structures—a Chinese wall system—shielding the individual making the decision. 17 C.F.R. §

from the offeror, target, or agents of either.[179] Thus, the rule would prohibit selective disclosure by the issuer even if the disclosure were wholly in the interest of the issuer. By its terms, finding a violation of rule 14e-3 *does not* require misappropriation from the acquiror nor does it require a breach of fiduciary duty by the tipper and participation by the tippee in the breach.[180] The conduct of Boesky clearly violated the rule. He received and traded on information from Levine and others knowing that it was material, nonpublic, and obtained from the offeror.

Two substantial legal questions are raised by the rule and its application to Boesky and legitimate risk arbitrage. First, is the rule statutorily authorized?[181] Second, if authorized, is the rule only en-

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240.14e-3(b) (1988). The rule also permits sales to the offeror and the use of agents for purchases by the offeror. *Id.* § 240.14e-3(c). Finally, the rule permits good faith communications relating to tender offers made to certain issuer and officers. *Id.* § 240.14e-3(d).

[179] *Id.* § 240.14e-3(a), (d). The duty arises if the purchaser knows or has reason to know that the information came from a prohibited source. *Id.* § 240.14e-3(a). Not only does this standard dispense with the pecuniary gain aspect of the tipping rules, but it also raises questions as to what culpability level is required. The language in rule 14e-3 supported a liability finding without scienter in *In re* Hutchinson, 534 A.2d 919 (D.C. 1987). *See also Suspension of Lawyer Who Tipped, Then Lied to SEC Affirmed on Appeal*, 19 Sec. Reg. & L. Rep. (BNA) No. 49, at 1882 (Dec. 11, 1987). In *Hutchinson*, an attorney was suspended from the practice of law for conveying and acting on material, nonpublic information. 534 A.2d at 925, 927-28. The court concluded that intent is not required for a conviction under rule 14e-3—mere negligent communication would suffice. *Id.* at 923-25. But similar language in section 10(b) has been interpreted as requiring scienter. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[180] The duty to disclose will arise under Rule 14e-3 when (1) "[an offeror] has taken a substantial step . . . to commence . . . a tender offer [and the tippee has] possession of material information relating to such tender offer"; (2) the tippee knows or should know that the information is nonpublic; (3) the tippee knows or should know that the information came from the offeror; and (4) the tippee trades in securities involved in the tender offer. 17 C.F.R. § 240.14e-3(a) (1988). *See generally* Tender Offers, 45 Fed. Reg. 60,410, 60,413 (Sept. 12, 1980) (discussing the duty to disclose under rule 14e-3).

[181] *See generally* ABA Comm. on the Federal Regulation of Securities, *Report of the Task Force on Regulation of Insider Trading*, 41 BUS. LAW. 223, 248-52 (1985) (discussing the broad reach of the gap-filling effect of rule 14e-3 and questioning whether the Commission had the authority to impose such a rule after *Chiarella*); Heller, Chiarella, *SEC Rule 14e-3 and* Dirks: *"Fairness" versus Economic Theory*, 37 BUS. LAW. 517, 541-46 (1982) (analyzing the legislative history of rule 14e-3 and suggesting that the SEC rationale for the adoption of the rule is contrary to the efficient capital market theory); Poser, *Misuse of Confidential Information Concerning a Tender Offer as a Securities Fraud*, 49 BROOKLYN L. REV. 1265, 1284-86 (1983) (pointing out two doubts as to the validity of rule 14e-3: First, "are the activities proscribed by the rule 'in connection with any tender offer,' as required by section 14(e)?; and second, is the rule consistent with the *Chiarella* decision?" (footnote omitted)); Wang, *Recent Developments in the Federal Law Regulating Stock Market Inside Trading*, 6 CORP. L. REV. 291, 306-08 (1983) (stating limitations on rule 14e-3); Note, *Trading on Material Nonpublic Information Under Rule 14e-3*, 49 GEO. WASH. L. REV. 539, 540 (1981) (discussing "significant disparities between the approach of the current members of the Supreme Court and the approach of the SEC . . . [and] conclud[ing] that regulatory, judicial, and legislative efforts should focus on developing a consistent, workable approach to control 'insider trading' ").

forceable through governmental actions or are private actions also permitted?[182] These legal questions impact on the business of risk arbitrage in several ways. If the section 10(b) misappropriation theory ultimately is rejected by the Supreme Court, then section 14(e) and rule 14e-3 are the only remaining vehicles for attacking Boesky-like conduct.[183] As described above, rule 14e-3 reaches conduct that otherwise would be legal under the *Newman-Dirks* line of cases. This raises the question whether the extended reach adversely affects legitimate risk arbitrage.

Rule 14e-3 was adopted by the SEC under its section 14(e)[184] and 23(a)[185] rulemaking authority. The operative language in section 14(e) prohibits "fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer."[186] The SEC has authority under the section to formulate rules "reasonably designed to prevent" such fraud.[187] The equivalent operative language of section 10(b) gives the SEC rulemaking authority to prohibit "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities.[188] While the word *fraud* appears in 14(e) but not 10(b), the Supreme Court in *Schreiber v. Burlington Northern, Inc.*[189] held the language of the statutes *in pari materia.*[190] How then can the equivalent 14(e) language support the SEC's rule 14e-3 with a broader duty to abstain from trading or disclose than section 10(b)? Some snippets of legislative history, particularly from the 1970 amendments granting the SEC section 14(e) rulemaking authority, support the

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[182] *See* cases cited *supra* note 177.

[183] The Supreme Court has yet to affirmatively rule on the validity of the misappropriation rule. In its most recent opportunity to consider the theory, Carpenter v. United States, 108 S. Ct. 316 (1987) (4-4 decision), the Court split on whether the theory existed as a means of establishing liability under rule 10b-5. *Id.* at 320.

[184] Williams Act § 14(e), 15 U.S.C. § 78n(e) (1982).

[185] Securities Exchange Act of 1934 § 23(a)(1), 15 U.S.C. § 78w(a)(1) (1982). Section 23(a) is a broad catch-all provision granting the Commission authority to "make such rules and regulations as may be necessary or appropriate to implement the provisions [of the 1934 act]." *Id.* The rules adopted under this section may be expansive but the Commission must explain why "any burden on competition by such rule or regulation is necessary or appropriate in furtherance of the purposes of . . . [the Act]." *Id.* § 23(a)(2), 15 U.S.C. § 78w(a)(2).

[186] *Id.* § 14(e), 15 U.S.C. § 78n(e).

[187] *Id.*

[188] *Id.* § 10(b), 15 U.S.C. § 78j(b) (1982).

[189] 472 U.S. 1 (1985). The *Schreiber* Court also stated the Commission has authority "to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts." *Id.* at 11 n.11 (quoting 15 U.S.C. § 78n(e) (1982)).

[190] After discussing the purpose and legislative history of the Williams Act, the *Schreiber* Court concluded that the intent of the Congress was that the term "manipulative" takes on a meaning in section 14(e) that is no different from the meaning it has in 10(b), and that as used in section 14(e) it requires misrepresentation or nondisclosure. *Id.* at 7-8.

broader duty.[191] An SEC staff report produced at Senator Williams' request specifically refers to granting the Commission authority to regulate when

> a person who has become aware of a tender offer is to be made or has reason to believe that such bid will be made, may not fail to disclose material facts with respect thereto to persons who sell to him securities for which the tender bid is to be made.[192]

The meaning of this legislative history raises fundamental and controversial questions of administrative law and interpretation of statutes. We live in an age of statutes.[193] As a consequence, there has been a recent explosion of scholarship concerning proper methods of statutory interpretation.[194] The question of the reach of section 14(e) presents a classic problem of the sort that causes considerable debate among scholars. Obviously, the starting point in interpreting legislation is the language itself.[195] If section 10(b) jurisprudence is followed, this language is not supportive of an informational equality thrust.[196] The text of section 14(e), however, contains the type of

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[191] H. R. REP. NO. 1655, 91st Cong., 2d Sess., *reprinted in* 1970 U.S. CODE CONG. & ADMIN. NEWS 5025; *see* D. LANGEVOORT, *supra* note 2, at 237 (summarizing the legislative history); *see also* Note, *supra* note 181, at 547 & nn.50-54 (suggesting a broad reading of rule 14e-3 and providing legislative history to support this interpretation).

[192] *Hearings on S. 336, S. 3431: Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 91st Cong., 2d Sess. 12 (1970); *see also* 116 CONG. REC. 29,252 to 29,253 (1970) (remarks of Senator Williams providing language supporting "equal footing" notions). But the Congressional debates in 1970 were almost exclusively concerned with disclosure by offerors and targets. It should also be remembered that nothing in the 1970 amendments changed the substantive definition of 14(e) fraud. Rather, the 14(e) amendment only granted the SEC rulemaking authority. Williams Act, Pub. L. No. 91-567, § 2, 84 Stat. 1497, 1497 (1970).

[193] G. CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 1 (1982).

[194] *See* Maltz, *Statutory Interpretation and Legislative Power: The Case for a Modified Intentionalist Approach*, 63 TUL. L. REV. 1 (1988) (summarizing recent literature on statutory interpretation).

[195] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring).

[196] It is axiomatic that no SEC rule can exceed "the power granted the Commission by Congress." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976). It is also axiomatic that the starting point for interpreting the power of the Commission is the language of the statute. *Id.* at 197 (citing *Blue Chip Stamps*, 421 U.S. at 756). Moreover, "the interdependence of the . . . securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen." SEC v. National Sec., Inc., 393 U.S. 453, 466 (1969). Like language should be interpreted similarly. A. SUTHERLAND, STATUTORY CONSTRUCTION § 51.02 (4th ed. 1984). Additionally, in *Hochfelder*, the Court seemed to require substantial support from the legislative history to expansively grant the SEC authority not supported by rather precise statutory language. 425 U.S. at 214. When, however, statutory language supports the Commission the Court has been willing to interpret the securities laws broadly to fulfill their prophylactic purposes. *See, e.g.*, SEC v. Jerry T. O'Brien, Inc., 467 U.S. 735, 745 (1984). Furthermore, the Court has used current policy concerns in addition to historical perspectives to interpret the language of the 1933 and 1934 Acts. *See, e.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299,

indeterminate language that leaves an interpreting court no choice but to look outside the text for some clues as to its meaning.[197]

By analogy the limiting section 10(b) jurisprudence provides strong extrinsic evidence. But, the legislative history of section 14(e) and similar statutes, as well as the agency's own views on the meaning of the section are also relevant.[198] A regulatory agency is usually given

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310, 315 (1985) (analyzing the *in pari delectio* defense to an action brought under rule 10b-5 "eschew[ing] rigid common-law barriers in construing the securities laws," preferring rather to "promote the primary objective of the federal securities laws—protection of the investing public and the national economy"); Landreth Timber Co. v. Landreth, 471 U.S. 681, 689-92 (1985) (discussing whether the *Howey* "economic realities" test, *see* SEC v. W.J. Howey Co., 328 U.S. 293 (1946), should be applied to "traditional stock, plainly within the statutory definitions"). In *Jerry T. O'Brien, Inc.*, the Court stated that "[e]specially in the context of securities regulation, . . . speed in locating and halting violations of the law is so important," and declined to require that the SEC inform a target that it has issued a subpoena to third parties. This is an example of dynamic statutory construction. 467 U.S. at 750-51.

[197] The *Chiarella* Court itself intimated that if there had been some specific extrinsic evidence suggesting liability for horizontal trading, the result may have been different. Chiarella v. United States, 445 U.S. 222, 236 (1980).

[198] *Id.* at 226. When the actions of Congress since *Chiarella*, *Dirks*, and *Newman* are factored in, the rule 14e-3 authority issue becomes even more complex. Professor Eskridge has suggested some rules to interpret congressional intent when legislative inaction is involved. Eskridge, *Interpreting Legislative Inaction*, 87 MICH. L. REV. 67 (1988). Professor Eskridge divides legislative inaction cases into three categories. One category—the "reenactment cases"— involves legislative inaction following an administrative interpretation of a statute. *Id.* at 79-84. He views the inaction to signify acceptance of that interpretation by the Congress. Professor Eskridge infers that Congress has approved of the administrative interpretation because it focused on and amended the statute without changing the provision in question. *Id.* at 79.

Meanwhile, Congress has passed two pieces of directly relevant legislation since *Chiarella*. The Insider Trading Sanctions Act of 1984 added the civil treble damages provision. Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984) (codified as amended at 15 U.S.C. § 78u(d)(2) (Supp. V 1987)). Remedies were enhanced further in the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677. *See* Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALB. L. REV. 893 (1988) (discussing the recently enacted legislation).

Each act purports to make no change in substantive law, yet the legislative histories of both acts contain authoritative statements taking debatable positions on substantive issues of inside trading law. Moreover, throughout this period, efforts were being made to statutorily define inside trading, but these efforts failed. The various committees debated whether the uncertainty over the legitimacy of both the misappropriation theory and the status of rule 14e-3 should be resolved by affirmatively adopting these rules or whether an effort at defining inside trading would leave the law frozen in undesirable ways. Congress may have resolved the question with respect to the misappropriation theory by approving its use in section 10(b) and rule 10b-5 cases. HOUSE REPORT, *supra* note 78, at 10, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6047.

Concerning rule 14e-3, it might be argued that because the SEC's interpretation evinced in rule 14e-3 had been " 'fully brought to the attention of the public and Congress,' " *see* United States v. Rutherford, 442 U.S. 544, 554 n.10 (1979) (quoting Apex Hosiery Co. v. Leader, 310 U.S. 469, 487-89 (1940)), Congress has given its blessing. *See* HOUSE REPORT, *supra* note 78, at 11, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6048; Eskridge, *supra*, at 79. Yet this approval was in the face of the contemporaneous 4-4 division of the court in United States v. Carpenter, 108 S. Ct. 316 (1987), on the validity of the misappropriation theory and some deference in interpreting the reach of its authority, especially if it participated in the drafting of the legislation as here.[199] The explosion in the size and importance of the market for corporate control and the size of the Boesky scandal itself also fundamentally changes the policy and societal context in which inside trading in tender offers is considered. A sea of change has occurred even since the time *Chiarella* was decided. Therefore, Professor Eskridge's dynamic factors in statutory interpretation lends the agency some support for an expansive reading of its authority.[200] The doubts concerning legislative authority for the rule are legitimate but the arguments for legitimacy are also forceful.

Congress should resolve these questions with a definition of inside trading in the tender offer context.[201] Market participants including

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positive approval by the same Congressional committee of the section 10(b) tipping theory in Dirks v. SEC, 463 U.S. 646 (1983). Thus, arguments about the meaning of reenacted and rejected proposals appear to cut both ways in this instance. The 1988 House Committee report claiming that "[t]he legal principles governing insider trading cases are well-established and widely-known" is the only statement that one can claim is clearly wrong. HOUSE REPORT, *supra* note 78, at 11, *reprinted in* 1988 U.S. CODE CONG. & ADMIN. NEWS 6043, 6048.

[199] *See* United States v. National Ass'n of Sec. Dealers, Inc., 422 U.S. 694, 718-19 (1975); *see also infra* note 201 (discussing the SEC's proposals). At the time of the 1970 amendments the most authoritative statement on the meaning of section 14(e) was by Judge Friendly in Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937, 940-41 (2d Cir. 1969). Judge Friendly stated he believed that, except for questions of standing, 14(e) was merely a codification of existing section 10(b) case law. *Id.*

The weight to be given administrative agency judgments interpreting statutory authority is best described by Diver, *Statutory Interpretation in the Administrative State*, 133 U. PA. L. REV. 549 (1985). Professor Diver concludes that two competing traditions exist on the deference to be given to interpretations by administrative agencies. *Id.* at 551. One tradition gives to courts a primary, independent role in determining the scope of an agency's authority, while another tradition gives agencies considerable leeway in shaping the delegated legislative mandate. *Id.* The choice in a particular instance of which tradition to follow involves a rich mix of factors which should lead to a rebuttable presumption of deference to interpretations lying within the agency's prima facie policymaking domain. *Id.* at 598-99.

[200] Eskridge, *supra* note 198, at 71-78.

[201] To date the suggestion has been rejected. During the debates concerning the Insider Trading Sanctions Act of 1984, proposals to define inside trading were spurned. *See The Insider Trading Proscriptions Act of 1987: Hearings on S. 1380 Before the Subcomm. on Securities of the Comm. on Banking, Housing, and Urban Affairs*, 100th Cong., 1st Sess. (1987) [hereinafter *Hearings on S. 1380*]; *id.* at 67 (testimony statement of Kenneth J. Bialkin, Esq.); *id.* at 98 (response to Written Questions of Senator Riegle from Professor James D. Cox); *see also* Langevoort, *The Insider Trading Sanctions Act of 1984 and Its Effect on Existing Law*, 37 VAND. L. REV. 1273, 1286-87 (1984) (describing the main cause for hesitation in defining insider trading as the fear of being confined to that definition instead of allowing the flexibility that exists without a definite statement); Junewicz, *Insider Trading Act Is Needed, But Without Defining the Term*, Nat'l L.J., Apr. 30, 1984, at 24, col. 3. The SEC argued against such a definition at that point. The Commission was concerned that such a substantive effort would kill attempts to promulgate the Commission's remedies proposals. *See* Flaherty, *Should an Insider Be Defined*, Nat'l L.J., Apr. 30, 1984, at 3, col. 2. The SEC was also concerned that a congressional definition of inside

risk arbitragers may be deterred from legitimate data collection efforts which benefit all market participants due to uncertainty about the proper bounds of liability under section 14(e) and rule 14e-3.[202]

As a policy matter, the general doctrinal limits under section 10(b) and rule 10b-5 on inside trading developed by the Court are correct. The section 10(b) and rule 10b-5 misappropriation limitations and pecuniary gain requirements allow firms to communicate efficiently with the market while making a business decision as to the best mode of communication. These tests also deter secret communications when there are high risks that a disloyal agent will harm the owner of the information, and thus derivatively harm shareholders of firms

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trading would create ambiguities and simultaneously give prospective evildoers a road map for successful violations because the SEC's flexibility would be reduced. *Id.* It was also concerned that any drafting effort might lead to a result which would unduly restrict professional traders, specifically including risk arbitragers.

Throughout 1987 and 1988 efforts to settle on a statutory definition of inside trading continued. *See, e.g., Definition of Insider Trading, supra* note 156, at 5. These efforts ultimately centered on S. 1380, a bill drafted by a group of prominent securities lawyers chaired by Harvey Pitt and introduced by Senators Riegle and D'Amato. The original version of S. 1380 contained a "wrongful trading" standard in both the horizontal and vertical types of inside trading, essentially codifying United States v. Newman, 664 F.2d 12 (2d Cir. 1981), and modifying Dirks v. SEC, 463 U.S. 646 (1983), to look only at the wrongful actions of the tippee in trading as being determinative. *See* S. 1380, 100th Cong., 1st Sess., *reprinted in Hearings on S. 1380, supra,* at 48-51. The pecuniary gain of the tipper was not necessary for tippee liability. The tipper could, however, be independently liable for any wrongful tip. *Id.* § 2(c)(1), *reprinted in Hearings on S. 1380, supra,* at 49-50. Wrongfulness was comprehensively defined as misappropriation and any similar breach of any contractual or other relationship when there was an apparent expectation of confidentiality. *Id.* § 2(b)(1), *reprinted in Hearings on S. 1380, supra,* at 49. Section 2(c)(2) of S. 1380 contained a more specific tipping rule relating to all control transactions. *Id.* § 2(c)(2), *reprinted in Hearings on S. 1380, supra,* at 50. That section would have prohibited tipping material, nonpublic information for the purpose of influencing securities transactions unless the tippee was part of the purchasing group or was being solicited for membership in the group. *Id.* These tests were intended to be exclusive; S. 1380 would have superceded rule 14e-3.

The SEC responded with two versions of a definition. SEC Proposed Insider Trading Bill, Nov. 18, 1987, *reprinted in Hearings on S. 1380, supra,* at 28-30. The final November 17, 1987 version was a compromise resulting from expert drafting by the committee in consultation with the SEC. This draft was primarily a codification of *Newman* and a modified *Dirks,* except that it attempted to codify the rule 14e-3 prohibitions. Like S. 1380, the SEC bill also made the tipper independently liable for a wrongful tip. *Id.* § 2(b), *reprinted in Hearings on S. 1380, supra,* at 28-29. The Commission stated that the legislative history of the bill should reflect that analysts perform essential functions in creating market efficiency and that routine communications between analysts and firms were not wrongful. The Commission believed that rulemaking to protect analysts was necessary.

[202] The effect of legal uncertainty on limiting legal risk arbitrage has been noted by market participants. Miller, *An Arb Defends His Livelihood,* 21 INSTITUTIONAL INVESTOR, Apr. 1987, at 106-13. In other areas of the law, such as antitrust, the desire for legal certainty has formed the basis for a limited construction of the statute by the Court. *See* United States v. United States Gypsum Co., 438 U.S. 422, 438 (1978).

participating in control transactions. Under current section 10(b) interpretation, the conduct of Boesky, Levine, and Siegel is reached. In contrast, the expanded duties of secrecy promoted by rule 14e-3 ignore the agency control focus and may hinder the role of risk arbitragers in creating an efficient market for tender offer securities. With a less efficient market, spreads will be larger, forcing non-professional investors to bear a larger fraction of the deal risk. Also, rule 14e-3 may create some enhanced entrenchment of a target's current management. Perhaps this explains part of the political support obtained by the SEC for the enhanced duties created by the rule.[203]

One aspect of current tender offer practice that the misappropriation-pecuniary gain approach leaves in an uncertain state is the problem of consensual "prearbitrage," or warehousing.[204] This practice is already, in part, limited by the group concept contained in section 13(d)(3).[205] Even before the commencement of any tender offer, some

[203] Haddock & Macey, *Regulation on Demand: A Private Interest Model, With an Application to Insider Trading Regulation*, 30 J. LAW & ECON. 311 (1987). Critics who believe the pecuniary gain test for illegal tipping is too narrow cite the following hypotheticals: (1) a firm releases material, nonpublic information for the purpose of merger, commercial negotiations, or financing. This information is then used by the receiving party for trading purposes rather than the intended purpose, *see, e.g.*, Walton v. Morgan Stanley & Co., 623 F.2d 796 (2d Cir. 1980); SEC v. Lund, 570 F. Supp. 1397 (C.D. Cal. 1983); (2) a hypothetical plain theft case: X, otherwise unrelated to Company A, uses industrial espionage to obtain material, nonpublic information about A and then trades on it. *See, e.g.*, *Definition of Insider Trading*, *supra* note 156, at 30 (joint statement of Harvey Pitt and John Olsen). In the first case, if the releasing company wanted the information to remain confidential, private ordering through a contractual promise of secrecy may form the basis for a state law action or a temporary-insider trading case similar to *Lund*. Also, if the facts of the first hypothetical demonstrate that a partial purpose of the firm's release was to allow the receiving party to pecuniarily benefit and share that benefit with the releasing firm in the contractual negotiations, conventional notions of inside trading would prevent the subsequent trading usage. This should be equated with direct trading by the disclosing firm, which would be illegal. The espionage hypothetical is equivalent to direct misappropriation, a primary violation under the *Newman* theory. Also, other criminal laws such as mail fraud seem sufficient to deal with this conduct.

[204] Warehousing involves issuer-motivated tipping in advance of the offer to place target stock in friendly hands before the offer commences. The extent to which traders engage in warehousing is limited for two reasons. A high volume of open market purchasing could cause a pre-tender price increase which harms the purchaser. Also, the group concept under section 13(d) requires reporting at an early stage in the process. 15 U.S.C. § 78m(d)(3) (1982). A related practice, "parking," is defined as the "temporary diversion of securities positions from the account of the real party in interest to the account of someone else." Rath, *supra* note 83, at 327. Parking is "[t]ypically . . . used by broker-dealers to avoid exposure of net capital or margin problems," and to "secretly" acquire stock for a takeover. *Id.*

[205] 15 U.S.C. § 78m(d)(3) (1982). Section 13(d)(3) provides that "two or more persons act[ing] as a partnership . . . or other group for the purpose of acquiring, holding, or disposing of securities of an issuer . . . shall be deemed a 'person' for the purposes of this [reporting requirements] subsection." *Id.*

connected purchases of related persons must be disclosed under 13(d).[206] The combination of a purchase and an understanding with the raider constitutes a group purchase which counts toward the five percent trigger requiring ownership reporting.[207] Moreover, even if consensual secret prearbitrage activity is limited by 13(d), a raider can signal its intentions in a variety of ways without making any direct communication about its plans; alternatively it can strategically reveal its identity as a beachhead builder before required to do so by section 13(d).[208] These practical avenues and legal restrictions make it doubtful whether a special rule on "prearbitrage" is needed beyond 13(d) and the rules of *Chiarella* and *Dirks*.[209]

B. Leveraging: The Margin and Net Capital Rules

If a risk arbitrager can borrow funds for less than the rate of return on an unleveraged arbitrage position, he can enhance his overall rate of return by financing the investment with debt.[210] A risk arbitrager's ability to do so, however, is limited by two separate sets of regulations. First, the margin rules, in broad outline, limit the percentage of securities which may be purchased on credit.[211] Second, the SEC's

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[206] *Id.* § 78m(d).

[207] *See id.*; 17 C.F.R. § 240.13d-3 (1988) (defining beneficial ownership). Additionally, the individuals will be subject to public disclosure as a consequence of the Hart-Scott-Rodino premerger notification requirements, 15 U.S.C. § 18(a) (1982), and will be limited to purchases after the offer commences, *see* 17 C.F.R. § 240.14e-3(a) (1988) (substantial step toward commencing tender offer).

[208] *Definition of Insider Trading*, *supra* note 156, at 68-70 (statement of Richard Phillips, Chairman, NYSE Legal Advisory Committee, Subcommittee on Tender Offers).

[209] *See supra* notes 115-33 (discussing *Chiarella*); *supra* notes 147-63 (discussing *Dirks*).

[210] For an explanation of the mechanics of leveraging, see W. KLEIN & J. COFFEE, *supra* note 50, at 4-7 (3d ed. 1988).

[211] The major margin regulations are contained in Regulation T. 12 C.F.R. §§ 220.4, .5, .18 (1988). *See* BRADY REPORT, *supra* note 4, at VI-15, VI-23 to -26 (providing a brief description of the operation of the margin rules). Although the margin regulations were promulgated by Congress, the SEC is charged with enforcement through the Board of Governors of the Federal Reserve System. Securities Exchange Act of 1934 § 7(a), 15 U.S.C. § 78g(a) (1982). These regulations only impose initial margins. *See* 12 C.F.R. § 220.1 (1988). The initial margin requirements are 50% for long positions, and 150% for short positions. *Id.* § 220.18(a), (c). The regulations for maintenance margins for broker-dealers are established by self-regulatory organizations (SROs). *See* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 665 (1988). The 1934 Act envisioned this type of self regulation "under the general aegis of the SEC." *Id.* at 36-37. The four types of SROs existing today are the national securities exchanges, the National Association of Securities Dealers, Inc., registered clearing agencies, and the Municipal Securities Rulemaking Board. *Id.* at 37. The minimum maintenance margins on the New York Stock Exchange are 25% for long positions, 30% for short positions, and 10% for offset long-short positions. *Id.* at 665 (citing NYSE rule 431(c)-(e); Exchange Act Release No. 24,144, 52 Fed.

net capital rules, which come into play because risk arbitragers are usually brokers and dealers in securities, require a minimum amount of capital to be held against the market value of securities in the portfolio of a securities dealer.[212] The margin and net capital regulations determine how much capital an arbitrager can devote to a particular investment position. The Boesky scandal and the events of October 19th raise questions about both regulatory schemes and their effect on the activities of risk arbitragers.

Boesky's participation in the violation of the margin rules[213] and the October 19th market break refocused attention on the utility of the margin rules as a protector of market solvency and controller of market volatility.[214] The proper margin level for the derivative instruments that risk arbitragers use to hedge is a particularly important issue in this reevaluation, as well as in the business of risk arbitrage.

Federal regulation of securities margins, including securities options, is a product of the stock market crash of 1929. Margin regulation was mandated by the Securities Exchange Act of 1934.[215] In contrast, margin requirements for futures used in hedging operations are only regulated by the exchanges, and during emergencies, by the Commodities Futures Trading Commission.[216] In mandating margin rules

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Reg. 7245 (Feb. 27, 1987)). Lenders often require higher margins for these loans. MARKET BREAK STUDY, *supra* note 4, at 5-12. Certain types of broker-dealer borrowing are only subject to good faith margin requirements. L. LOSS, *supra*, at 661. Such transactions include market making transactions. *See id.*

Standardized stock options also are securities and thus are subject to federal margin regulation. Securities Exchange Act of 1934 § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1982). The purchaser of the option is prohibited from buying on credit. The writer of the option is subject to various requirements as a consequence of SRO regulation, including the posting of margins equivalent to the forecasted liquidation cost of the position. This requirement is marked to market daily.

[212] 17 C.F.R. § 240.15c3-1 to -3 (1988). This net capital rule provides that "[n]o broker or dealer shall permit his aggregate indebtedness to all other persons to exceed 1500 percent of his net capital." *Id.* § 240.15c3-1(a).

[213] To accomplish some of Boesky's trading practices he induced Jefferies & Co. to aid and abet his violation of the margin rules. *See* SEC v. Jefferies, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,171 (S.D.N.Y. Mar. 19, 1987). Boyd Jefferies was charged with holding securities for Boesky's broker-dealer, Seemala Corporation, thereby permitting Seemala to exceed the net capital limitations. *Id.* at 95,761; *see also* Rath, *supra* note 83, at 31-32.

[214] Boyd Jefferies and Kidder Peabody were charged with buying stock for Boesky thereby extending him credit beyond the 50% margin limitations. *Jefferies*, [1987 Transfer Binder] Fed. Sec. L. Rep (CCH) at 95,761-62.

[215] Securities Exchange Act of 1934 § 7, 15 U.S.C. § 78(g) (1982). This regulatory authority reaches trading on stock options as well as the underlying equity security.

[216] 7 U.S.C. § 12a(9) (1982). Futures markets margins are generally set by the exchanges. Future margins technically do not involve protection of a credit relationship but rather operate as a performance bond, attempting to ensure performance of the obligation of the contract. Margins on futures are marked to market daily. Thus, futures winners and losers in effect settle up daily. Because margins on futures are smaller than margins on the underlying stocks, an

for securities, Congress was concerned that trading on credit diverted funds from more productive investments, that such trading caused undue volatility in the market, and that margin trading caused many investors to assume unsuitable credit positions that were inconsistent with their resources and investment goals.[217] The rules were also intended to protect margin lenders against undue threats to their own solvency.

Subsequent research into the 1929 crash and the developing nature of the financial markets led to serious questions concerning whether the margin regulations served any purpose and whether the private decisions of market actors were sufficient to protect the markets. Investigations of the 1929 stock market crash showed that brokerage firms and other margin lenders were amply protected in their relationships with debtors by private arrangements, even in the absence of government regulation.[218] Credit providers adequately balanced solvency concerns with their interest in creating trading volume. Modern financial research also suggests that credit purchases of securities neither absorb real savings in the economy nor change the risk preferences of the investment community in any significant way. The financial system also seems able to carry a substantial amount of credit used to finance securities purchases. Moreover, investors can be protected against inappropriately induced margining through suitability lawsuits,[219] rather than through across-the-board regula-

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investor can take a larger position in the market by leveraging futures rather than investing in the securities themselves. *See* BRADY REPORT, *supra* note 4, at VI-63 to -70 (discussing the futures and options markets).

Even before October 19th, the exchanges were making an effort to create margins for derivative instruments on a basis associated with accurate measurements of risk. Heston, *How Margining Systems Are Measuring Risk Better*, FUTURES: THE MAGAZINE OF COMMODITIES & OPTIONS, June 1987, at 60-63. In the attempt to promote efficient trading, margin requirements should offer some protection against the risk of default on the contract while not discouraging trading or reducing liquidity. Assessment of margin levels for derivative instrument positions must include consideration of the volatility of the underlying contract, time until expiration, interest rates, and underlying prices.

[217] Staff of the Board of Governors of the Federal Reserve System, A Review and Evaluation of the Federal Margin Regulations, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,728 (Dec. 1984) [hereinafter Federal Margin Regulations Review]; *see also* Staff of the Federal Reserve Bank of New York, Securities Credit Regulations of the Board of Governors of the Federal Reserve System, pt. I, ch. II, at 13 (1978) [hereinafter Federal Reserve Bank Staff Report].

[218] *See* H.R. REP. NO. 1383, 73d Cong., 2d Sess. 4 (1934). The House Report asserted that the Stock Market Crash of 1929, in large part, was due to unbridled purchases of securities on credit. *Id.* at 2-3. Even before the recent burst of deregulation literature, this claim was criticized. J. GALBRAITH, THE GREAT CRASH OF 1929, at 174 (1954).

[219] *See* T. HAZEN, THE LAW OF SECURITIES REGULATION § 10.7, at 275-77 (1985). Suitability law suits are actions brought against a broker-dealer on the grounds that the broker-dealer's

tions which restrict what could be a sensible investment strategy for a sophisticated investor.[220] The volatility concern continues to be the major remaining modern justification for securities margin regulations.[221]

Before October 19th, critics of the margin rules created some pressure for the deregulation of margin transactions.[222] The continuing review of financial market regulation challenged much of the structure of the post-Great Crash approaches.[223] Many participants in the financial markets suggested that market-based solutions could cure even solvency or volatility problems.[224] The pressure for deregulation was also prompted by the growth of trading in different types of futures and options index contracts, and the potential to obtain a more leveraged investment through the use of derivative trading instruments.[225] Market participants demanded a "level playing field" in whatever regulatory approach was chosen.[226] The argument was raised that all economically comparable leveraged transactions should be treated equivalently, regardless of form.[227]

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recommendations of a particular security was not suitable for the customer. *Id.* at 275-76. Various SROs impose the suitability rule upon broker-dealers, and this may impose an affirmative obligation on the broker-dealer to inquire into a customer's objectives or financial needs. *Id.* at 276. A claim under rule 10b-5 or other federal regulation on suitability grounds alone when a broker induced a margin purchase would present somewhat novel federal securities legal issues, but such cases have been litigated under state law. *See generally* S. JAFFEE, BROKERS-DEALERS AND SECURITIES MARKETS: A GUIDE TO THE REGULATORY PROCESS (1977 & Supp. 1988); N. WOLFSON, R. PHILLIPS & T. RUSSO, REGULATION OF BROKERS, DEALERS, AND SECURITIES MARKETS § 2.08 (1977).

[220] All the margin rules might do for such a sophisticated investor is force that investor to use a less efficient method of raising funds such as mortgaging other property.

[221] *See* Federal Reserve Bank Staff Report, *supra* note 217, at 13. Perhaps at the outer bounds, October 19th showed that some type of solvency concern also remains. *See infra* note 235. The SEC noted that the volatility of the market increased 380% for the week of October 19th. MARKET BREAK STUDY, *supra* note 4, at 4-6. The SEC stated that volatility concerns "ha[ve] affected all market participants." *Id.* at 4-24.

[222] As early as 1966 it was recognized that the margin rules did not fulfill any of the goals that Congress envisioned for them except perhaps the volatility limitation goal. Moore, *Stock Market Margin Requirements*, 74 J. POL. ECON. 158, 167 (1966). The rules could in fact have the perverse effect of driving investors who wish to bear substantial risk into heavy purchases of risky securities rather than using leverage. Rizzi, *Portfolio Theory, Capital Markets, and the Marginal Effect of Federal Margin Regulations*, 8 LOY. U. CHI. L.J. 499, 509 (1977). This would cause capital to be misdirected into the purchase of risky securities. *Id.* The margin rules might also cause investors to be less diversified in their portfolios than they might otherwise be. *Id.*

[223] *See* Federal Margin Regulations Review, *supra* note 217, at 87,279.

[224] *See* Macey & Miller, *Bank Failure, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153, 1223-25 (1988).

[225] *See* MARKET BREAK STUDY, *supra* note 4, at 3-19 to -22 (noting that derivative trading instruments such as futures and options have lesser margin requirements and therefore permit greater leveraging).

[226] *See* Rizzi, *supra* note 222, at 510.

[227] *See* Federal Margin Regulations Review, *supra* note 217, at 87,280.

The October 19th market break spawned increased interest in the problems of the level playing field and increased concerns that unduly leveraged positions lead to undesirable volatility.[228] On October 19th the margins on futures and index options ranged from three to five percent while stock margins for certain traders were at an effective level of twenty to twenty-five percent.[229] For other traders the margin equalled fifty percent.[230] Although reviews of the role of derivative instruments and margins on the October 19th market break are contradictory,[231] it seems likely that in those unique market circumstances, the lower margins on derivative instruments drove investors to those vehicles, and, through market interlinkages, increased volatility in the equity markets.

October 19th thus led to proposals to increase margins on derivative instruments. Increasing derivative instrument margins, however, may lead to less liquidity across all securities markets,[232] particularly in normal market situations. The effect on risk arbitrage could be especially severe because the increased amount of capital needed to maintain a hedged position over longer periods of time would be greater.

Conversely, deregulation of margins could lead to greater use of margin purchases.[233] As a group, risk arbitragers are not risk averse. They undoubtedly would attempt to borrow more than they currently do. As a consequence, if lenders allowed increased margining, arbitragers would rapidly buy more securities related to control transactions, leading to increased liquidity. Information would then be communicated more efficiently to the market through the price-signalling mechanism. The result should be a competitive reduction of spreads. More trading by arbitragers would lead to a higher fraction of the transaction price in the hands of those risk adverse investors selling into the market. From this perspective, margin-induced liquidity aids in the smooth operation of the market for corporate control.[234]

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[228] Rubinstein, *Portfolio Insurance and the Market Crash*, 44 FIN. ANALYSTS J., Jan.-Feb. 1988, at 38-47.

[229] *See* MARKET BREAK STUDY, *supra* note 4, at 3-20.

[230] *Id.*

[231] *See* Karmel, *The Rashomon Effect in the After-the-Crash Studies*, 21 REV. SEC. & COMMODITIES REG. No. 12, at 101 (June 22, 1988).

[232] MARKET BREAK STUDY, *supra* note 4, at 3-22; Fishe & Goldberg, *supra* note 16, at 261-71.

[233] *See* Dennis, *supra* note 16, at 424. In the absence of regulation, the precise amount of increased margining is difficult to predict. In some situations, brokers-dealers today routinely require margins above the minimums that are mandated by the Federal Reserve Board or SROs. MARKET BREAK STUDY, *supra* note 4, at 5-12.

[234] When I last reviewed the subject of risk arbitrage and the margin rules, I concluded margin

Even without regulation the private arrangements of borrowers and lenders appear to be generally sufficient to protect solvency.[235] Less certain is whether the liquidity benefit of low margins should be sacrificed so that volatility is reduced. Perhaps a solution to balancing the liquidity and the low volatility goals is to impose position limits on both futures and options index products.[236] The position limitation approach is tailored more carefully to match unusual market circumstances than a mandated across-the-board increase in margin levels. This solution would allow risk arbitragers to use highly leveraged hedging techniques while in part limiting the volatility risk that such conduct creates. Since the post-October 19th political environment makes fundamental deregulation of margins an unrealistic policy option, the practical regulatory goal should now be to ensure that any new regulations have as little damaging effect on liquidity as possible. The position limit approach facilities this desirable goal.[237]

The Boesky scandal also raises questions about the validity of the SEC's net capital rules. Before the Boesky scandal, the relationship between the net capital rules and risk arbitrage was only of interest to the back office managers of arbitragers; but Boesky found a way to make violations of these requirements part of his operating procedures. Seemala Corporation, a registered broker-dealer, was Boesky's principal trading vehicle.[238] For three months in 1986 Seemala violated the net capital rules.[239] This violation was hidden through bogus sales to Seligman Harris, a London and New York broker.[240] Seemala entered into a secret agreement by which these trades would be

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deregulation for risk arbitrage was a realistic policy option. Dennis, *supra* note 16, at 424. The October 19th market break has made this approach politically unviable.

[235] In connection with the October 19th market break, a number of firms suffered losses sufficient to raise concerns about their liquidity. MARKET BREAK STUDY, *supra* note 4, at 5-3 to -9. Some of these problems arose from customer margin defaults. *Id.* at 5-4. As a consequence of risk arbitrage activities, at least two trading firms suffered sufficient solvency difficulties to fall below the net capital requirements of the SEC. *See id.* at 5-8 to -9. But stringent net capital rules reduce the need for margin rules as a backup to solvency regulation.

[236] Address by David Ruder, Chairman of the SEC, The Impact of Derivative Insider Trading on the Securities Markets, The Bond Club of Chicago 16 (Oct. 6, 1987) (*cited by* MARKET BREAK STUDY, *supra* note 4, at 3-22).

[237] To the extent that the net capital rules function properly, the role of margin regulation, especially as a solvency tool, is reduced.

[238] SEC v. Kidder Peabody & Co., [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,271, at 96,350 (S.D.N.Y. June 4, 1987); United States v. Davidoff, 19 Sec. Reg. & L. Rep. (BNA) No. 6 (Feb. 6, 1987).

[239] *Kidder Peabody & Co.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,271, at 96,350.

[240] *Davidoff*, 19 Sec. Reg. & L. Rep. (BNA) No. 6, at 198.

reversed before settlement or delivery, and Seemala would receive all of the profits or losses from the transactions.[241] The transactions were intended to enable Seemala to retain ownership of the securities without making a true sale even though the firm's net capital was below the required minimum.[242] This violation strikes at the core of the net capital rules. Seemala's conduct does, however, present an opportunity to review the role of the net capital rules to determine whether they strike a proper balance between allowing aggressive risk arbitrage and protecting solvency.

The net capital rules for brokers and dealers are also products of the 1934 Act.[243] The rules are intended to protect solvency through requirements of liquidity. The SEC has had net capital rules since 1942,[244] buttressed by the net capital solvency rules of self-regulatory organizations—primarily the New York Stock Exchange.[245] The major thrust of these regulations is to protect the general investing public as well as professional investors from losses as a consequence of a broker-dealer insolvency.[246] The back-office crisis of broker-dealers in the late 1960s and early 1970s led to a revamping of the regulation of the financial integrity of broker-dealers.[247] The crisis showed that an industry shakeout could threaten even a major first line brokerage firm. In response to the solvency crisis, the net capital rules were significantly strengthened. As currently structured, the net capital rules require a broker-dealer to maintain a minimum amount of liquid assets and a minimum ratio of liquid assets to debt.[248] The rules provide two methods of calculating financial ratios[249] and contain

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[241] *Id.*

[242] *Id.*

[243] Securities Exchange Act of 1934 §§ 15(c)(3), 17(a), 23(a), 15 U.S.C. §§ 78o(c)(3), 78q(a), 78w(a) (1982); 17 C.F.R. § 240.15c3-1 (1988). The net capital rules limit the liabilities incurred by a broker to a portion of current assets; they were intended to ensure that brokers do not overextend themselves on credit.

[244] 7 Fed. Reg. 8844 (Oct. 29, 1942).

[245] N.Y.S.E. rule 325, *reprinted in* N.Y.S.E. CONSTITUTION AND RULES (CCH) ¶ 2325 (1988). Prior to 1975, the net capital rules exempted brokers who were members of an exchange and thus subject to that exchange's net capital rule. S. JAFFEE, *supra* note 220, § 13.01, at 283. In 1975, rule 15c3-1, 17 C.F.R. § 240.15c3-1 (1988), was amended to apply equally to exchange members and other brokers and dealers. *See* Adoption of Amendments to Rule 15c3-1 and Adoption of an Alternative Net Capital Requirement for Certain Brokers and Dealers, Exchange Act Release No. 11,497, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,212 (June 26, 1975).

[246] For a comprehensive description of the operation of the rules, see N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 220, at §§ 6.01-8.06, ch. 6-8 (1977 & Supp. 1985). S. JAFFEE, *supra* note 220, § 13.01; MARKET BREAK STUDY, *supra* note 4, at 5-1 to -3.

[247] For a history of the liquidity crisis, see Wolfson & Guttman, *The Net Capital Rules for Brokers and Dealers*, 24 STAN. L. REV. 603 (1972).

[248] 17 C.F.R. § 240.15c3-1(a) (1988).

[249] *Id.*

detailed accounting methods for valuing assets and liabilities used in the calculations.[250] The calculations of the worth of assets and liabilities are intended to reflect the market and credit risks of the firm's various securities positions so that a solvency cushion is created.[251] Additionally, several other regulatory financial integrity initiatives were promulgated. Brokers were required to segregate investors' securities held by the broker more stringently,[252] and an early warning financial reporting system was adopted.[253] An insurance system was also approved to protect customers of broker-dealers.[254]

The failure of a major brokerage firm today, with our interrelated financial markets, certainly would be a financial disaster. The financial difficulties of several broker-dealers after October 19th demonstrate that, at least as a consequence of extraordinary events, concerns about solvency remain.[255] The scope of regulation needed to prevent significant insolvencies, however, deserves serious reconsideration.[256] The early warning reporting system and the requirement that brokers segregate securities reduce the pressure to apply net capital rules as the primary method of regulating solvency. At the same time, however, the insurance system reduces managerial incentives for solvency.[257] The safeguards afforded by brokers' insurance allows aggressive management of firm capital which places stress on the system, as dem-

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[250] *Id.* § 240.15c3-3a.

[251] *See generally* S. JAFFEE, *supra* note 220, § 13.01; N. WOLFSON, R. PHILLIPS & T. RUSSO, *supra* note 220.

[252] 17 C.F.R. § 15c3-3 (1988).

[253] The SEC early warning system is called FOCUS and requires prompt reporting when net capital drops below a stated amount. *Id.* § 240.17a-5. The self-regulatory organizations also systematically monitor financial integrity. *See, e.g.,* N.Y.S.E. Const. § 2, *reprinted in* N.Y.S.E. CONSTITUTION AND RULES (CCH) § 1002 (1988).

[254] The federal insurance plan is authorized by the Securities Investors Protection Act, Pub. L. No. 91-598, 84 Stat. 1636 (codified at 15 U.S.C. § 78aaa-lll (1982)). Government-backed insurance plans make decision-making in regulation of financial markets all the more difficult. Such insurance plans are important as a basis for consumer confidence, and therefore are crucial in capital formation promotion, but these plans marginally reduce the incentives of managers to promote solvency. Thus government regulation may be needed to reintroduce the optimal amount of solvency motivation. For a discussion of a related problem in the regulation of banks, see Macey & Miller, *supra* note 224, at 1153.

[255] *See* BRADY REPORT, *supra* note 4, at VI-64 to -69.

[256] The SEC has had a long-term interest in reevaluating its solvency regulations. *See* SEC, Study of the Financing and Capital Needs of the Securities Industry, Fed. Sec. L. Rep. (CCH) No. 1109 (Jan. 23, 1985); Net Capital Requirements for Brokers and Dealers, Exchange Act Release No. 21,651, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,726 (Jan. 11, 1985); MARKET BREAK STUDY, *supra* note 4, at 5-14 to -48.

[257] The SEC's program to monitor managerial behavior through negligence suits against broker-dealers for financial mismanagement might remove some of the effect insurance has on managerial behavior. *See* Barnes, *NASD Regulation of Firms in Financial Difficulties*, 21 REV. SEC. & COMMODITIES REG. No. 19, at 187 (Nov. 2, 1988).

onstrated by the October 19th market break. The net capital rules, like the solvency rules for other financial institutions, thus continue to play some salutary role that cannot be filled by solely market-based incentives.[258] Furthermore, no evidence has been produced to demonstrate that the net capital rules themselves cause a shortage of risk arbitrage capital. From this perspective, the demand for risk arbitrage capital should not drive any effort to change the required net capital levels.

C. Professional Trading Advantages and the Tender Offer Timing and Proration Rules

In addition to restrictions on inside trading and limitations on leverage, another major area in which regulations have been adopted to limit the professional trading advantages of risk arbitragers is the SEC tender offer timing and proration rules.[259] The proration rule applies to any partial or two-tiered tender offer.[260] In such offers, all shareholders who tender within the proration period must be treated equally if the offer is oversubscribed.[261] The proration period extends throughout the entire period during which the offer stays open.[262] Offers must remain open for at least twenty business days.[263] In addition, rule 10b-4 now prohibits short or hedged tendering of target stock.[264]

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[258] For a defense of liquidity-based rules, see Molinari & Kibler, *Broker-Dealers' Financial Responsibility Under the Uniform Net Capital Rule—A Case For Liquidity*, 72 GEO. L.J. 1 (1983). Molinari and Kibler argue that the net capital rules remain important despite the recent reforms in the financial responsibility structures and the clearance system. *Id.* at 12-18. They suggest that timing issues with respect to segregation and the cyclical nature of the securities industry cause the net capital rules to remain important. *Id.* at 25-33.

[259] Securities Exchange Act of 1934 § 14(d)(6), 15 U.S.C. § 78n(d)(6) (1982); 17 C.F.R. § 240.14d-8 (1988). Section 14(d)(6) provides that in the event of a tender offer "for less than all the outstanding equity securities of a class . . . the securities taken up shall be taken up as nearly as may be pro rata . . . according to the number of securities deposited by each depositor." 15 U.S.C. § 78n(d)(6) (1982).

[260] 17 C.F.R. § 240.14d-1 (1988).

[261] See *infra* note 264 for a description of the effect of proration on a risk arbitrager's return.

[262] 17 C.F.R. § 240.14e-1 (1988).

[263] *Id.*

[264] *Id.* § 240.10b-4. The hedged tendering rule does not prohibit the kinds of hedging which use derivative instruments. Rather the rule prohibits short tendering of the target stock. *See id.* In 1968 the SEC adopted a version of rule 10b-4 which prohibited short tendering, *i.e.*, tendering more target shares than an investor owned in order to avoid or reduce the risk of proration. Tendering Securities Not Owned, Exchange Act Release No. 8231, 33 Fed. Reg. 8269 (June 4, 1968); *see also* Bache & Co. v. International Controls Corp., 324 F. Supp. 998, 1004

The dynamics of the current market for corporate control have reduced the relative number of partial or two-tiered offers.[265] Never-

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(S.D.N.Y. 1971), *aff'd*, 469 F.2d 696 (2d Cir. 1972). The rule was designed to promote equality among all tendering shareholders. After this rule was adopted, risk arbitragers began to hedge-tender, that is, immediately after tendering the total amount of shares owned, the arbitrager sells short into the market the expected number of shares which would be returned as a consequence of proration. The short position is then covered by the returned shares. *See* SEC v. Weisberger, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,108 (S.D.N.Y. June 3, 1975) (granting SEC's request for injunctive relief against defendants' attempt to tender stock of a target company that they did not own, in violation of rule 10b-4). For a comprehensive discussion of the rule against short tendering, see R. FERRARA, M. BROWN & J. HALL, *supra* note 55, at 110-12. The amended rule now requires the tendering shareholder to be in a "net long" position when the proration period ends. 17 C.F.R. § 240.10b-4 (1988). The effect of the amended rule is to increase the risk of proration to all tendering shareholders. This results in lowering the price an arbitrager will be willing to pay in the market during the proration period.

[265] A two-tier tender offer has been described as one which is comprised of "two different prices: A higher price for shares tendered immediately (the 'front end') and a lower price for shares purchased for cash or securities in a subsequent merger (the 'back end')." R. FERRARA, M. BROWN & J. HALL, *supra* note 55, at 123. The strategy is designed so that the offeror pays a higher price for a number of shares which allows it to gain control of the company; upon the acquisition of control, it merges the target company into itself. It may then "freeze out" the owners of the unbought shares by coercing them into selling out at a substantially lower price. At a minimum, the time value of money reduces the value of the second step. This is in accord with the offeror's primary purpose for the two-tiered offer to pay a premium only for the shares needed to acquire control, and then to effect a freeze-out after the merger by requiring the remaining shareholders to sell to the offeror at a lower price. *See* I. BOESKY, *supra* note 3, at 93-100; *see also* Comment, *The Front-End Loaded, Two-Tiered Tender Offer*, 78 NW. U.L. REV. 811, 812 n.9 (1983) (discussing large, well-publicized two-tiered tender offers, including offers by: U.S. Steel for Marathon Oil, *see* Radol v. Thomas, 534 F. Supp. 1302 (S.D. Ohio 1982); Bendix for Martin Marietta Corp., *see* Martin Marietta Corp. v. Bendix Corp., 547 F. Supp. 533 (D. Md. 1982); and Whittaker for Brunswick, *see* Whittaker Corp. v. Edgar, 535 F. Supp. 933 (N.D. Ill. 1982)); *see also* R. FERRARA, M. BROWN & J. HALL, *supra* note 55, at 124 (noting the infrequency of such partial or two-tiered offers in recent years); Comment, *supra*, at 813 n.14 (noting commentators who hypothesized that the new regulations would make the two-tiered tender offer less attractive).

State corporate law probably contributes to this phenomenon. The Delaware courts give managers more deference in adopting and using defensive tactics when the control transaction takes the form of a partial or two-tiered offer. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Managers in such transactions would most likely not be required to waive a poison pill. *See* Moran v. Household Int'l Inc., 500 A.2d 1346 (Del. 1985). Additionally, fair price corporate charter provisions and the new generation of state takeover statutes create disincentives for partial or two-tiered offers. *See* DEL. CODE ANN. tit. 8, § 203 (Supp. 1988) (business combination antitakeover statute); MASS. ANN. LAWS ch. 110C, §§ 1-13 (Law. Co-op 1985) (barring the offeror from making a takeover bid if he owns 5% or more of the stock in the target company which shares were purchased within one year of the proposed takeover bid); N.J. STAT. ANN. §§ 14A:10A-1 to -6 (West Supp. 1988) (business combination antitakeover statute); N.Y. BUS. CORP. LAW §§ 1600-1613 (McKinney 1986) (requiring disclosure at commencement of takeover bid and barring the use of fraudulent or deceptive practices); *see also* R. FERRARA, M. BROWN & J. HALL, *supra* note 55, at 507-28; Kreider, *Corporate Takeovers and the Business Judgment Rule: An Update*, 11 J. CORP. LAW 633, 647-48 (1986); Veasey, Finkelstein & Shaughnessy, *The Delaware Takeover Law: Some Issues, Strategies and Comparisons*, 43 BUS. LAW. 865 (1988).

theless, such offers do occur in some transactions.[266] When relevant, the proration and hedged tendering regulations have a significant impact because they increase the risk in risk arbitrage. In calculating the value of an offer, an arbitrager must make certain assumptions concerning the amount of shares not accepted for purchase because of proration and the value of the returned shares after the control transaction closes. The more shares that are returned to the tendering shareholder, the lower the potential value of the transaction to that investor. After the transaction is completed, the returned shares will usually trade at a price somewhat below the tender offer price.[267]

The extended offering and proration periods were promulgated by the SEC to give investors sufficient time to evaluate the terms of the offer.[268] Without such additional time, the SEC believed arbitragers would be able to use their professional trading advantages to tender more promptly and obtain an undue share of the tender offer premium.[269] Nonprofessional investors would be whipsawed into tendering without adequate information.

The SEC's statutory authority for extending the offering and proration periods is questionable.[270] Statutory interpretation questions aside, an important policy question is presented by the SEC's approach. First, it not clear that public shareholders were injured by the prior short offering period and ten day proration period.[271] There was no empirical evidence that nonprofessional investors were unable to participate in offers and proration pools under the ten day rule. Arbitragers do account for a substantial proportion of the trading during the pendency of partial or two-tiered offers, but this means

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266 For example, the RJR-Nabisco leveraged buyout took the form of a two-tiered offer because of the lower value of the securities offered in the second step.

267 Comment, *supra* note 265, at 812.

268 *See* Comment, *supra* note 70, at 1025-26.

269 *See* Comment, *supra* note 265, at 813.

270 In Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed?*, 19 GA. L. REV. 281 (1985), I argued that rule 14d-8 is inconsistent with the statutory language, legislative history, and judicial interpretation of the Williams Act. *Id.* at 286-89; *see also* Note, *SEC Tender Offer Timing Rules: Upsetting a Congressionally Selected Balance*, 68 CORNELL L. REV. 914 (1983) (positing that the SEC lacks the authority under revised rule 14d-8 to promulgate substantive timing regulations) [hereinafter Note, *SEC Tender Offer Rules*]; Note, *The Impact of* Schreiber *on the SEC Tender Offer Timing Rules*, 57 GEO. WASH. L. REV. 77 (1988) (asserting that the SEC rules contravened the intentions of Congress when it enacted the Williams Act) [hereinafter Note, *Timing Rules*]. The precise statutory language provides only for a ten day proration period. 15 U.S.C. § 78n(d)(6) (1982). As with rule 14e-3, the SEC claims statutory authority based upon an expensive reading of its section 14(e) rulemaking power. *See* Note, *SEC Tender Offer Rules*, *supra*, at 917-19.

271 *See* Pro Rata Rules, Exchange Act Release No. 19,336, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,306, at 85,560 (Dec. 15, 1982) (Shad, Comm'r dissenting) (adopting rule 14d-8).

their judgments—and the information on which those judgments are based—are swiftly communicated to the market through trading. A vigilant investor benefits from arbitrage activity by selling into the market or by tendering.

Second, the extended full offering period proration rule can injure the nonprofessional investor. If the longer proration period causes more investors to tender, or increases the risk of successful blocking techniques by target managers, lower relative prices will be available in the open market during the pendency of offers. High open market prices during the pendency of the offer benefit the nonarbitrager-investor. A related concern is that extended proration and offering periods increase risk for first bidders. More risk means that at the margin some offers are deterred. In these prevented offers there is no tender offer premium to allocate. Concurrently, the timing rules increase risk for tendering shareholders by making it more uncertain how many shares will be accepted. The timing rules also reduce the benefit of withdrawal rights.[272]

Rather than as an effort to promote trading equality or production of information, the offering period, proration, and the hedged tendering rules can best be justified as a method of creating the regulatory environment necessary for managers to mount an auction or negotiate with the raider. The auction and negotiating models for target managerial behavior can be defended as sound public policy for control transaction regulation.[273] This corporate governance goal is, however, far removed from the statutory sources of authority relied on by the SEC.[274] The uncertainty over the legitimacy of the rules has been exacerbated by the Supreme Court's holding in *Schreiber v. Burlington*

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[272] *Id.*

[273] Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1039-41 (1982). *But see* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) (arguing that facilitation of competing tender offers is undesirable). Auctions result in transferring the target's assets to a higher valued user. Moreover, managers can serve as efficient negotiating agents for shareholders. Auctions occur when the takeover target either solicits or receives takeover offers from a number of potential acquirors, ultimately accepting the most advantageous offer. *Id.* at 1-2. The recent thrust of state legislative and case law development supports the negotiating model. The delay in the tender offer process required by the Williams Act, and state takeover statutes make auctions and negotiations practical. *See* Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53, 57-73 (1985) (downplaying target management misbehavior and viewing target management as bargaining agents for target shareholders).

[274] Proposed Pro Rata Tender Offer Rule, Exchange Act Release No. 18,761 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,222, at 85,142 (May 25, 1982) (relying on section 14(e) of the act).

Northern, Inc.[275] The proper Congressional response should be a specific judgment as to whether the SEC should be empowered to regulate in areas that have been traditionally left to state law. The national market for tender offers is a powerful reason for allowing the Commission to determine the proper time frames for tender offers in light of the rapidly changing conditions in the market for corporate control.[276] But the reach of the Commission's authority should be guided and specific.

CONCLUSION

Risk arbitragers are important to the efficient operation of the market for corporate control. They help create liquidity and informational and fundamental market efficiency. They allow risk adverse nonprofessional traders ready access to a market price close to the transaction price. Yet the Boesky scandal showed that risk arbitragers can threaten the market through inside trading. Such trading can misappropriate the discovery value of information about the target from the raider. This discovery value is what fuels potential profit and thereby increases the frequency of transactions. The pecuniary gain/misappropriation test allows arbitragers to create the efficiency benefits without harming the raider. Thus, the current mix of financial controls allows risk arbitrage to go forward without harming the financial stability of the securities markets.

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[275] 472 U.S. 1 (1985); see also Note, *Timing Rules*, *supra* note 270, at 80 (discussing *Schreiber* 472 U.S. 1 (1985)).

[276] Note, *Timing Rules*, *supra* note 270, at 81.