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United States v. O'Hagan: The Eighth Circuit Throws the Second Strike to the Misappropriation Theory of Rule 10b-5 Liability*

I. INTRODUCTION

For over fifteen years, the Securities and Exchange Commission has used the controversial misappropriation theory to expand the Supreme Court's narrow interpretation of section 10(b)[1] and Rule 10b-5.[2] Recently, in *United States v. O'Hagan*,[3] the United States Court of Appeals for the Eighth Circuit expressly rejected the misappropriation theory, once again drawing attention to a distinct split in the federal circuits. Three other circuits[4] have openly adopted the misappropriation theory, and another circuit[5] appears to have adopted it as well. Until *O'Hagan*, only the Fourth Circuit had rejected the theory.[6] The Supreme Court has yet to address whether the misappropriation theory is reconcilable with the language and purposes of section 10(b) and Rule 10b-5. However, the problem has become so acute that the government decided to petition the Supreme Court for a writ of certiorari in *O'Hagan*, which the Court has granted.[7]

This Note argues that the Eighth Circuit's decision in *O'Hagan* is consistent with the language of both section 10(b)

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1. 15 U.S.C. § 78j(b) (1994).

2. 17 C.F.R. § 240.10b-5 (1996).

3. 92 F.3d 612 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

4. The Second Circuit in *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), was the first to openly adopt the misappropriation theory. The Seventh and Ninth Circuits followed the Second Circuit's lead in adopting this theory of liability. *See* SEC v. Maio, 51 F.3d 623 (7th Cir. 1995); SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990).

5. Arguably, the Third Circuit has adopted the misappropriation theory. *See* Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985).

6. *See* United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).

7. *See* United States v. O'Hagan, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

and Rule 10b-5 as interpreted by the Supreme Court. Part II summarizes the development of securities-fraud liability and introduces the dispute over the validity of the misappropriation theory. Part III briefly recites the facts and the court's reasoning in *O'Hagan*. Part IV analyzes the *O'Hagan* reasoning in light of section 10(b) and Rule 10b-5, their scant legislative history, and Supreme Court precedent. Part V concludes that the *O'Hagan* reasoning is properly grounded in Supreme Court precedent.

II. THE DEVELOPMENT OF RULE 10b-5 LIABILITY

A. *Section 10(b) and Rule 10b-5*

Following the Great Depression and the 1929 stock market collapse and in an attempt to curtail excessive abuses in the securities industry,[8] the Seventy-third Congress enacted the Securities Act of 1933 (the "1933 Act")[9] and the Securities Exchange Act of 1934 (the "1934 Act").[10] The 1933 Act regulates initial distributions of securities,[11] and the 1934 Act primarily regulates postdistribution trading, addressing all of the "aspects of securities transactions and the securities markets."[12]

8. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 170-71 (1994); *see also* C. EDWARD FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING 45 (1991).

9. Pub. L. No. 73-38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)).

10. Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj).

11. *See* FLETCHER, *supra* note 8, at 45. The Supreme Court has noted that the 1933 Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce, to protect investors against fraud and, through the imposition of specified civil liabilities, to promote ethical standards of honesty and fair dealing." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

12. 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION 513 (3d ed. 1995); *see also* FLETCHER, *supra* note 8, at 45. "The 1934 Act was intended principally to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." *Hochfelder*, 425 U.S. at 195. The 1934 Act established the Securities and Exchange Commission (the "SEC"). The SEC's primary mission was to regulate the stock market to ensure the integrity of the marketplace. *See generally* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 456-60 (1990). The prevailing view is that the 1934 Act's fundamental purpose was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963); *see also* Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1340-41 (1966).

One of Congress's major concerns was how to eliminate abusive insider trading.[13] Initially, the 1934 Act dealt with the problem only by mandating full disclosure by issuers in the requisite periodic reports and by creating section 16.[14] However, these mechanisms proved to be an ineffective means of curbing many of the perceived insider-trading abuses.

Section 10(b) of the 1934 Act prohibits the use "*in connection with* the purchase or sale of any security . . . [of] any *manipulative or deceptive* device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or *for the protection of investors*."[15] In 1942, pursuant to section 10(b),[16] the Securities and Exchange Commission (the "SEC" or "Commission") promulgated Rule 10b-5,[17] which makes it unlawful for any person to "employ any device, scheme, or artifice to defraud, [or] . . . [t]o 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*."[18] Section 10(b) and Rule 10b-5 are now the basic federal antifraud provisions used by the SEC.

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13. *See, e.g.*, Thel, *supra* note 12, at 425. The term "insider trading" is clearly a term of art. In general, the term refers to the trading of securities based on an illegal informational advantage. Traditionally, the term has been used in connection with self-dealing of corporate directors and officers who break faith with the company and its shareholders by using confidential company information for their own personal gain. However, any person who has access to material, nonpublic information may qualify as an insider. Insiders include the same statutory insiders as those regulated under section 16(b), as well as a range of company personnel and outsiders who gain access to such information in the course of their duties or through tips from insiders.

14. *See* 15 U.S.C. § 78p. Section 16, specifically subsection (b), prohibits short-swing profits by directors, officers, and principal shareholders of publicly held companies. *See id.* Section 16 was designed as the anti-insider trading section of the 1934 Act. *See* FLETCHER, *supra* note 8, at 45.

15. 15 U.S.C. § 78j(b) (emphasis added).

16. According to commentators, section 10(b) was originally meant to give the SEC the ability to reach novel forms of manipulative behavior that speculators might employ in trading securities on national exchanges, aiming to protect the integrity of the marketplace rather than particular investors. *See* Thel, *supra* note 12, at 442-49.

17. 17 C.F.R. § 240.10b-5 (1996).

18. *Id.* (emphasis added).

B. *Judicial Development of Section 10(b) and Rule 10b-5 Liability*

The SEC has continually maintained that one of its top priorities is to eliminate trading on inside information.[19] However, Congress has yet to make clear the types of securities trading that constitute "insider trading" and, more importantly, which types of such trading are permissible and which are not. Moreover, the law regarding the use of confidential information in securities trading has not developed systematically; the United States Supreme Court and several circuit courts have decided various notable cases involving the abuse of nonpublic, confidential, or proprietary information in securities trading.[20] Over the years, the greatest problem for the courts in deciding securities-fraud cases has been dealing with the broad language of both section 10(b) and Rule 10b-5. This broad language has allowed two theories of liability to emerge: the classical theory and the misappropriation theory. This Note will provide an overview of these two theories and the historical development of section 10(b) and Rule 10b-5 liability.

1. *The classical theory of liability*

Typically, section 10(b) and Rule 10b-5 trading cases have involved a defendant who has a fiduciary duty to the shareholders of the company in whose securities he traded.[21] This scenario has led to the so-called classical theory of Rule 10b-5 liability.[22] This theory is based on the traditional notion of "insiders" as directors, officers, or controlling shareholders who have access to material,[23] nonpublic corporate information by virtue of their

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19. *See* 2 HAZEN, *supra* note 12, at 598.

20. *See, e.g.*, Carpenter v. United States, 484 U.S. 19 (1987); Dirks v. SEC, 463 U.S. 646 (1983); Chiarella v. United States, 445 U.S. 222 (1980); Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972).

21. *See* SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

22. *See id.*; *see also* United States v. O'Hagan, 92 F.3d 612, 616 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

23. In order for information to be material "'there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information . . . available.'" Basic v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976)).

positions.[24] The classical theory imposes liability on one who buys or sells securities on the basis of confidential information in breach of his or her duty to the shareholders of the corporation whose securities are traded.[25]

2. The misappropriation theory of liability

An alternative theory of liability that some courts have adopted is known as the misappropriation theory. This theory imposes liability on an individual who (1) misappropriates confidential information (2) in breach of *any* duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction.[26] Unlike the classical theory, the misappropriation theory neither requires a duty to the corporation in whose shares the individual trades nor requires that a party to the securities transaction be defrauded.[27]

3. The early beginnings of section 10(b) and Rule 10b-5 liability

The judicial development of Rule 10b-5 liability began with the SEC's decision in *Cady, Roberts & Co.*,[28] in which the Commission determined that an insider must abstain from trading shares of his corporation unless he has first disclosed all material inside information known to him.[29] The SEC recognized that the common law in some jurisdictions imposes on traditional corporate "insiders," such as directors, officers, and controlling shareholders, an "affirmative duty of disclosure . . . when dealing in securities."[30] The SEC found, however, that not only did breach of this common-law duty establish the elements of a Rule

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24. *See* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

25. The Ninth Circuit was the first to use the term "classical" to identify the theory of liability the Supreme Court outlined in the seminal case of *Chiarella*, which theory the Court redefined in *Dirks*. *See Clark*, 915 F.2d at 443; *see also Dirks*, 463 U.S. at 653-67; *Chiarella*, 445 U.S. at 226-35.

26. The genesis of the misappropriation theory is found in Chief Justice Burger's dissenting opinion in *Chiarella*, *see* 445 U.S. at 239-45, but was first adopted by the Second Circuit in *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). The misappropriation theory "extends the reach of Rule 10b-5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade [and] focuses [on the breach of] a fiduciary duty to any lawful possessor of material non-public information." SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991).

27. *See* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc).

28. 40 S.E.C. 907 (1961).

29. *See id.* This rule has generally become known as the duty to "abstain or disclose."

30. *Id.* at 911 & n.13.

10b-5 violation, but that persons other than corporate insiders could violate the rule as well.[31] Thus, *Cady, Roberts & Co.* effectively broadened the scope of Rule 10b-5 to cover any relationship affording access to corporate inside information, not just the traditional "insider" relationship.[32] The Commission emphasized that a duty to abstain or disclose arises from (1) the existence of a relationship affording access to inside "information intended to be available only for a corporate purpose" and (2) the unfairness of allowing an insider to take advantage of that information by trading without disclosure.[33]

Following *Cady, Roberts & Co.* the Second Circuit continued to expand the boundaries of liability under section 10(b) and Rule 10b-5. In *SEC v. Texas Gulf Sulphur Co.*,[34] the Second Circuit held that corporate insiders possessing nonpublic information regarding a valuable mineral find who purchased stock on the open market had violated Rule 10b-5 because the information would have been "material" to a reasonable person's investment decision.[35] In sum, the Second Circuit held that "*anyone* in possession of material inside information must either disclose it to the investing public, or . . . abstain from trading."[36]

The Supreme Court decision in *Affiliated Ute Citizens v. United States*[37] marked the high point in the expansion of Rule 10b-5. In this case, the Court held that in a face-to-face transac-

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31. *See id.* at 912.

32. This has become known as the "equality-of-access" theory, premised on investor expectations regarding the relative accessibility of corporate information in market participants. *See* Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 346 (1979). Justice Blackmun embraced the equality-of-access theory in his dissent in *Chiarella v. United States*, 445 U.S. 222 (1980): "I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities." *Id.* at 251 (Blackmun, J., dissenting). The *Chiarella* majority, however, rejected the theory. *See id.* at 231 n.14.

33. *See Cady, Roberts & Co.*, 40 S.E.C. at 912. The Commission endorsed the reasoning of Judge Learned Hand that

> the director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induce the buyer into the position of a beneficiary although he was forbidden to do so once the buyer had become one.

Id. at 914 n.23 (quoting Gratz v. Claugton, 187 F.2d 46, 49 (2d Cir. 1951)).

34. 401 F.2d 833 (2d Cir. 1968) (en banc).

35. *See id.*

36. *Id.* at 848 (emphasis added); *see also supra* note 32 and accompanying text.

37. 406 U.S. 128 (1972).

tion, any purchaser in possession of material, nonpublic information has a duty to disclose such information to the seller before consummating a transaction.[38]

4. *The narrowing of the scope of section 10(b) and Rule 10b-5 liability*

In *Blue Chip Stamps v. Manor Drug Stores*,[39] the Supreme Court began to narrow the scope of Rule 10b-5. In this case, the Court addressed the issue of standing and whether a private action under Rule 10b-5 was limited to actual "purchasers" or "sellers" of securities.[40] In finding that a plaintiff must either be a buyer or a seller, the Supreme Court looked to the language of the statute itself, prior Court decisions, and the textual scheme of the 1933 and 1934 Acts.[41] In doing so, the Court laid the foundation to consider eventually whether only fraud in connection with the purchase or sale of securities falls within the reach of section 10(b).

The Supreme Court later examined the requisite intent for a Rule 10b-5 violation in *Ernst & Ernst v. Hochfelder*[42] and held that the scope of section 10(b) does not reach negligent conduct.[43] The SEC, in an amicus curiae brief, argued that the nature of the conduct was irrelevant and the real focus should be the "effect" on investors.[44] However, the *Hochfelder* Court rejected the "effect-oriented" approach because it ignored the plain language of the statute.[45]

One year after *Hochfelder*, the Supreme Court again considered the scope of section 10(b) in *Santa Fe Industries, Inc. v. Green*.[46] The Court reversed the Second Circuit by holding that section 10(b) only prohibits conduct that "can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute."[47] The Court made two points clear: (1) the statutory language

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38. *See id.*
39. 421 U.S. 723 (1975).
40. *See id.*
41. *See id.*
42. 425 U.S. 185 (1976).
43. *See id.* at 214. The Court reasoned that section 10(b)'s use of the terms "'manipulative and deceptive' . . . strongly suggest[s] that § 10(b) was intended to proscribe knowing or intentional misconduct." *Id.* at 197.
44. *See id.* at 198. The Court recognized that this kind of approach would impose liability for faultless conduct "where such conduct results in harm to investors." *Id.*
45. *See id.* at 199.
46. 430 U.S. 462 (1977).
47. *Id.* at 473-74.

must control the interpretation of the rule, and (2) the language only proscribes conduct involving manipulation or deception.[48]

Yet, it was not until the seminal case *Chiarella v. United States*[49] that the Supreme Court expressly defined the scope of section 10(b) and provided lower courts with an insider-trading standard for Rule 10b-5 liability. In *Chiarella* the Court addressed whether silence in connection with the purchase or sale of securities may operate as a fraud under section 10(b). The Court found that nondisclosure was within the purview of the statute, but that "such liability is premised on a duty to disclose arising from a relationship of trust and confidence."[50] Thus, the Court ostensibly adopted the *Cady, Roberts & Co.* reasoning that section 10(b) liability rests on a duty to abstain or disclose but narrowed that standard to require a duty based on a fiduciary relationship between corporate shareholders and those insiders who obtain confidential information by reason of their position in the corporation.[51] Further, the Court declared that "mere possession of nonpublic market information" does not give rise to such a duty under section 10(b).[52] The Supreme Court also stressed that it was unwilling to broaden the scope of the statute,[53] and that while section 10(b) "is aptly described as a catchall provision, . . . what it catches must be fraud."[54]

In his dissenting opinion in *Chiarella*, Chief Justice Burger announced his own reading of section 10(b), declaring that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[55] Chief Justice Burger's interpretation of the statute

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48. *See id.* at 472-74. The Court in *Santa Fe Industries, Inc.* made it clear that Rule 10b-5 does not extend to breaches of fiduciary duty absent "manipulation" or "deception." *See id.*

49. 445 U.S. 222 (1980).

50. *Id.* at 230.

51. *See id.* at 227-28. This duty finds its origin at common law where misrepresentation made for the purpose of inducing reliance on a false statement is fraudulent. *See id.* Yet "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so." *Id.* The duty to disclose arises only when there is a fiduciary or other similar relationship of trust or confidence present between the parties. *See id.* The Court, in maintaining that a duty in this context arises from the relationship between parties, vitiated any notions of the equality-of-access theory as a basis of Rule 10b-5 liability. *See id.* at 231-32 n.14.

52. *Id.* at 235.

53. *See id.* at 234-35

54. *Id.*

55. *Id.* at 240.

sparked the genesis of the misappropriation theory. The majority in *Chiarella* refused to consider such a theory of liability because it had not been presented to the jury.[56]

Three years after *Chiarella*, the Supreme Court reemphasized the principles of that decision in *Dirks v. SEC*,[57] holding that "'not all breaches of fiduciary duty in connection with a securities transaction' . . . come within the ambit of Rule 10b-5. There must also be 'manipulation or deception.'"[58] The Court in *Dirks* rejected the SEC's position that a "tippee"[59] who receives confidential information that she knows or should have known came from a corporate insider has a duty to abstain or disclose.[60] The Court instead held that a tippee's duty to abstain or disclose derives from the corporate insider's duty to shareholders.[61] If the insider's tip was a breach of her duty to shareholders, and the tippee knew or should have known it was a breach, then the tippee owed a similar fiduciary duty under Rule 10b-5.[62] The Court in *Dirks* also noted that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders."[63] The Court explained that the reason for recognizing this duty with respect to these specific outsiders is that these individuals enter into a "special confidential relationship" with the corporation, creating a fiduciary duty owed thereto, and are given access to information solely for corporate purposes.[64]

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56. *See id.* at 236.

57. 463 U.S. 646 (1983).

58. *Id.* at 654 (quoting Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472-73 (1973)).

59. The term "tippee" has been used generally to refer to an individual who receives material, nonpublic information from an insider.

60. *See Dirks*, 463 U.S. at 657-58.

61. *See id.* at 660.

62. *See id.* Thus, courts must first determine whether the insider has breached his fiduciary duty. "Whether disclosure is a breach of duty depends in large part on the purpose of the disclosure." *Id.* at 662. "[T]he test is whether the insider personally will benefit, directly or indirectly, from his disclosure." *Id.* Further, the Court in *Dirks* stated that the benefit that the insider receives from this disclosure is a benefit "such as a pecuniary gain or a reputational benefit that will translate into future earnings." *Id.* at 663.

63. *Id.* at 655 n.14.

64. *See id.* Thus, these individuals are considered "quasi-insiders" or "constructive insiders."

The *Chiarella* and *Dirks* holdings refined the so-called classical theory of insider-trading liability.[65] In sum, the Supreme Court has stated that it will not find liability for insider trading under Rule 10b-5 unless the individual owes a fiduciary duty to the corporation and its shareholders or is a tippee who received information from an insider of the corporation and knows or should know that the insider breached a fiduciary duty in disclosing the information to her.

C. Development of the Misappropriation Theory

Many courts, apparently dissatisfied with the narrowly tailored scope of the classical theory of insider trading articulated in *Chiarella* and *Dirks*, have embraced the broad misappropriation theory.[66] In adopting the theory, courts have expanded the scope of section 10(b) and Rule 10b-5 liability in order to resolve cases of perceived "financial unfairness."[67]

In *United States v. Newman*,[68] the Second Circuit applied Chief Justice Burger's so-called misappropriation theory to expand the application of Rule 10b-5 liability.[69] The *Newman* court outlined the requirements for Rule 10b-5 liability under the misappropriation theory.[70] In essence, any person who misappropriates material, nonpublic information in breach of any fiduciary duty and uses that information in a securities transaction is liable under Rule 10b-5.[71] The theory invokes criminal liability for a

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65. *See supra* note 25 and accompanying text.

66. *See supra* notes 4-6, 26. Since its inception in 1981, the misappropriation theory has consumed courts and commentators. The theory's development in the courts can be traced chronologically as follows: *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993); and *SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995).

67. *See* Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 183-84 (1995). Kenny and Thebaut contend that the circuit courts that have adopted the misappropriation theory have improperly imposed judicial policy on section 10(b) and Rule 10b-5. *See id.*

68. 664 F.2d 12 (2d Cir. 1981).

69. *See id.* at 15-19. Chief Justice Burger said that section 10(b) and Rule 10b-5 should be read to mean that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

70. *See Newman*, 664 F.2d at 19.

71. *See id.*; *see also* Clark, 915 F.2d at 443.

simple breach of virtually any type of fiduciary duty or similar relationship of trust and confidence, regardless of whether the person owes a duty to the shareholders of the traded securities.[72] For example, under the misappropriation theory, an employee of a newspaper is liable if he steals confidential information belonging to the newspaper regarding a third-party corporation and then trades in that third-party corporation's stock on the basis of such nonpublic information.[73] The theory also finds criminal liability whether or not the parties wronged by the breach of a duty were parties to, or otherwise connected with or interested in, the securities transaction.[74]

The Second Circuit later extended the reach of the misappropriation theory in *SEC v. Materia*[75] and *United States v. Carpenter*.[76] An eight-member panel of the Supreme Court had the chance to address the misappropriation theory in *Carpenter*, but divided evenly on the issue without stating the basis for the division.[77] The Second Circuit, undeterred, has continued to apply the theory.[78]

Arguably, three other circuits also have adopted the misappropriation theory. The Ninth Circuit, in *SEC v. Clark*,[79] concluded, based on a liberally applied linguistic analysis, that "the misappropriation theory fits comfortably within the meaning of 'fraud' in § 10(b) and Rule 10b-5."[80] Later, in *SEC v. Cherif*[81] the Seventh Circuit became the third circuit to grapple with and adopt the misappropriation theory. Also, many proponents of the

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72. *See* United States v. O'Hagan, 92 F.3d 612, 616-17 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842); United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995).

73. This example has been suggested by Jared L. Kopel and Rebecca L. Epstein at the law firm of Wilson Sonsini Goodrich & Rosati in Palo Alto, California. *See* Jared L. Kopel & Rebecca L. Epstein, *Stock Insider Trading Legal Theory Unsettled*, ¶ 1 (visited Feb. 11, 1997) <http://www.callaw.com/wilson/wilson3.html>.

74. *See Bryan*, 58 F.3d at 949-50; United States v. Chestman, 947 F.2d 551, 566 n.3 (2d Cir. 1991) (en banc).

75. 745 F.2d 197 (2d Cir. 1984).

76. 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided Court*, 484 U.S. 19 (1987).

77. *See* Carpenter v. United States, 484 U.S. 19 (1987).

78. *See Chestman*, 947 F.2d at 551; United States v. Grossman, 843 F.2d 78 (2d Cir. 1988).

79. 915 F.2d 439 (9th Cir. 1990).

80. *See id.* at 449.

81. 933 F.2d 403 (7th Cir. 1991).

misappropriation theory argue that the Third Circuit, in *Rothberg v. Rosenbloom*,[82] has adopted it.

The Fourth Circuit, however, threw the first strike to the misappropriation theory by categorically rejecting the theory in *United States v. Bryan*.[83] According to the court, the theory did not comport with the language of section 10(b), Rule 10b-5, the Supreme Court authority interpreting those provisions, or the purposes of the antifraud prohibitions.[84]

The *Bryan* court stated that the Supreme Court has repeatedly warned against expanding the scope of section 10(b) liability "beyond what the words of the Act reasonably will bear."[85] According to the *Bryan* court, the Supreme Court's consistent interpretation of section 10(b) has focused on deception by material misrepresentation or omission while the misappropriation theory lacks such a focus.[86] The court went further, however, by stating that even if the misappropriation theory did require deception, it would "not require deception violative of a duty of fair representation or disclosure owed to a market participant, *i.e.*, deception in connection with a purchase or sale of securities."[87]

III. *UNITED STATES V. O'HAGAN*

A. *The Facts*

James H. O'Hagan was a partner at the Minneapolis-based law firm of Dorsey & Whitney which represented Grand Met PLC ("Grand Met"), a large, London-based company, as local counsel in preparation for the acquisition of the Pillsbury Company ("Pillsbury"), headquartered in Minneapolis.[88] Prior to the announcement of Grand Met's tender offer, O'Hagan purchased 2,500 Pillsbury call options[89] and nearly 5,000 shares of Pillsbury

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82. 771 F.2d 818 (3d Cir. 1985).

83. 58 F.3d 933 (4th Cir. 1995).

84. *See id.* at 944.

85. *Id.* at 945.

86. *See id.* at 949.

87. *Id.*

88. United States v. O'Hagan, 92 F.3d 612, 614 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

89. The term "option" refers to a stock option—a negotiable instrument for which a person has paid a certain sum of money that gives the person the right to buy certain specified shares of stock, if the person so desires, at any time within an agreed time period, at a fixed price. If the option gives the right to buy, or not buy, it is denominated a "call." Thus, the term "call option" refers to a negotiable instrument whereby the option writer, for a certain sum of money (the "premium"), grants to the

common stock.[90] Following the tender offer, Pillsbury's stock nearly doubled in value. O'Hagan then exercised his options, liquidated his holdings, and realized a profit of over $4,000,000.[91]

The SEC then began an investigation, which culminated in a fifty-seven-count indictment; O'Hagan was charged with sixteen counts of securities fraud in violation of section 10(b) and Rule 10b-5.[92] Although O'Hagan may have owed a fiduciary duty to Dorsey & Whitney and Grand Met, he clearly did not owe one to Pillsbury. Since he did not trade in Grand Met securities, he could not be liable under the classical theory. The Commission therefore based its securities-fraud case on the misappropriation theory of liability.[93] A jury convicted O'Hagan on all fifty-seven counts.[94] He appealed to the Eighth Circuit contending that the misappropriation theory was an impermissible basis on which to impose liability under section 10(b).[95] The Eighth Circuit agreed and vacated all of O'Hagan's securities fraud convictions.[96]

B. *The Reasoning*

The *O'Hagan* court first examined the language of section 10(b) and Rule 10b-5.[97] The court, based on language from both *Central Bank v. First Interstate Bank*[98] and *Chiarella v. United States*,[99] declared that when determining the scope of section

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option buyer the irrevocable right to demand, within a specified time period, the delivery by the option writer of a specified number of shares of a stock at a fixed price (the "exercise" or "strike price"). *See* BLACK'S LAW DICTIONARY 204, 1094 (6th ed. 1990). "For example, on August 18, 1988, O'Hagan purchased 100 Pillsbury call options. Each call option gave him the right to purchase 100 shares of Pillsbury stock. Each call option also expired on September 17, 1988, if the option was not exercised." *O'Hagan*, 92 F.3d at 614 n.1.

90. *See O'Hagan*, 92 F.3d at 614.

91. *See id.*

92. *See id.* This Note deals solely with the court's treatment of the securities-fraud conviction under section 10(b) and Rule 10b-5.

93. *See, e.g.*, United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc).

94. *See O'Hagan*, 92 F.3d at 614.

95. *See id.* at 615.

96. *See id.* at 627.

97. *See id.* at 615.

98. 511 U.S. 164 (1994).

99. 445 U.S. 222 (1980).

10(b) the text of the statute is dispositive.[100] The court resolved not to extend liability to conduct which falls beyond what the text of the statute explicitly prohibits.[101]

The court then determined that "deception" is the focus of section 10(b) and that "fraud" is the focus of Rule 10b-5.[102] The court concluded that the SEC had included "fraud" in Rule 10b-5 as a means of defining the scope of conduct proscribed by section 10(b).[103] The court supported its conclusion that Rule 10b-5 fraud must also be deception within the meaning of the statute with language from the *Chiarella* opinion.[104]

Following its foundational analysis of the text and its scope, the court addressed the classical and misappropriation theories of liability.[105] The court rejected the misappropriation theory as an impermissible basis of liability because the Supreme Court had not validated it, and, according to the Eighth Circuit, the theory did not comport with the Court's "teachings on the scope of conduct reachable under section 10(b)."[106]

In rejecting the misappropriation theory, the *O'Hagan* court reviewed Supreme Court opinions on the scope of section 10(b). The court divided its analysis into two prongs, determining that (1) the misappropriation theory fails to require "deception" as required by section 10(b), and (2) the theory fails to require that

100. *See O'Hagan*, 92 F.3d at 616. The Supreme Court in *Central Bank* stated that "[w]ith respect . . . to the scope of conduct prohibited by § 10(b), the text of the statute controls our decision." 511 U.S. at 173. The Court in *Chiarella* reemphasized that "the 1934 Act cannot be read 'more broadly than its language and the statutory scheme reasonably permit.'" 445 U.S. at 234 (quoting Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979)).

101. *See O'Hagan*, 92 F.3d at 617. The Supreme Court in *Central Bank* reiterated that it had "refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute." 511 U.S. at 173. The Court, in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), also stated that "in deciding whether [challenged conduct constitutes] 'fraud' under Rule 10b-5, 'we turn first to the language of § 10(b).'" *Id.* at 472 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976)).

102. *See O'Hagan*, 92 F.3d at 615.

103. *See id.*

104. *See id.* The Supreme Court in *Chiarella* stated that "[s]ection 10(b) is aptly described as a catchall provision, but what it catches must be fraud." 445 U.S. at 234-35 (1980).

105. *See O'Hagan*, 92 F.3d at 616-17.

106. *Id.* at 617.

the "deception" be "in connection with the purchase or sale of any security."[107]

In its first prong of analysis, the court declared that the misappropriation theory violates the *Santa Fe Industries, Inc.* requirement that deception cannot be premised on the mere breach of a fiduciary duty, but must also be accompanied by misrepresentation or lack of disclosure.[108] Relying on the decisions in *Central Bank* and *Santa Fe Industries, Inc.*, the court stated that the Supreme Court has repeatedly held that misrepresentation or nondisclosure is required by section 10(b).[109] The court found that the misappropriation theory does not require "deception" as mandated by the statute.[110] Thus, the court rejected the misappropriation theory because it permits section 10(b) liability based on a mere breach of any fiduciary duty.[111]

The court then determined in its second prong of analysis that the misappropriation theory must be rejected because it permits liability for a breach of duty owed to persons who are unconnected to a securities transaction, rendering meaningless the "in connection with" language of section 10(b).[112] The court stated that a "careful reading" of *Dirks*, *Chiarella*, and *Central Bank* reveals that only a breach of duty to parties involved in the securities transaction, or to other market participants, will be sufficient to give rise to section 10(b) and Rule 10b-5 liability.[113] Since the misappropriation theory imposes liability even though no party to the securities transaction or market participant was deceived or defrauded, the court declared that it "'transform[s section 10(b)] from a rule intended to govern and protect relations among market participants' into an expansive 'fraud-on-the-source theory.'"[114] Further, the court was unpersuaded that the "touch" test,[115] as presented by the government, satisfied the

107. *See id.* at 616-22. The *O'Hagan* court declared that even assuming that the misappropriation theory does require "deception," it "renders nugatory the requirement that the deception be in connection with the purchase or sale of any security." *Id.* at 617.

108. *See id.* at 618.

109. *See id.*

110. *Id.* at 617.

111. *See id.* at 618.

112. *See id.*

113. *See id.*

114. *Id.* at 619 (quoting United States v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995)).

115. *See infra* note 209 and accompanying text.

"in connection with" requirement; according to the court, such a theory is too broad and cannot be defended.[116]

Recognizing that at least three[117] and arguably four[118] other circuits had adopted the misappropriation theory, the *O'Hagan* court stated that those circuits had not conducted "as rigorous an analysis" of the statutory language and Supreme Court precedent as it had.[119] The *O'Hagan* court noted that the origins of the misappropriation theory were located in the *Chiarella* dissent[120] and addressed the underlying policy rationale used to support it. But the court determined that the misappropriation theory is inconsistent with Supreme Court precedent.[121] The court also noted that "the language of § 10(b), not Rule 10b-5, determines the scope of conduct that the statute reaches."[122]

The court concluded its analysis by discussing certain policy arguments supporting its holding[123] and declared that the securities industry requires predictability.[124] For example, because the misappropriation theory applies to an overly broad range of situations involving a breach of virtually any fiduciary duty, it frustrates the policy of predictability.[125]

IV. ANALYSIS

While three or four circuits have adopted the misappropriation theory, the Eighth Circuit in *O'Hagan* appropriately rejected the theory on the strong foundation of Supreme Court precedent. Part IV.A looks to the text of section 10(b) and its legislative history, and Part IV.B addresses the language of Rule 10b-5 and its legislative history. Next, Part IV.C discusses how the Supreme Court has narrowly interpreted section 10(b) and Rule 10b-5 in articulating a coherent standard for applying liability thereunder. In Part IV.D, this Note explores the ways in which proponents of the misappropriation theory have attempted to reconcile the theory with the language of section 10(b), Rule 10b-5, and Supreme Court precedent. Finally, Part IV.E addresses certain

116. *See O'Hagan*, 92 F.3d at 619-20.
117. *See supra* note 4 and accompanying text.
118. *See supra* note 5 and accompanying text.
119. *See O'Hagan*, 92 F.3d at 621.
120. *See id.*
121. *See id.* at 620-22.
122. *Id.* at 621.
123. *See id.* at 622.
124. *See id.*
125. *See id.*

policy concerns that strongly discourage the application of the misappropriation theory. Together, these sections illustrate the importance of the *O'Hagan* decision and show why the Eighth Circuit properly rejected the misappropriation theory.

A. *Section 10(b) and Its Legislative History*

The Supreme Court has made it clear that the starting point for Rule 10b-5 cases is the language of the statute, section 10(b).[126] Further, when analyzing an agency-created rule, one must first turn to the language of the enabling statute.[127] Unfortunately, both Rule 10b-5 and its statutory enabler, section 10(b), are "notoriously vague."[128]

In enacting the 1934 Act, the President and Congress aimed to eliminate "as far as possible the use of these [securities and commodities] exchanges for purely speculative operations . . . for the protection of investors [and] for the safeguarding of values."[129] Yet, section 10(b) does not proscribe any conduct; Congress merely provided the SEC with the authority to "prescribe [rules] as necessary or appropriate in the public interest or for the protection of investors."[130] The drafters of the 1934 Act and members of Congress commenting on section 10(b) believed that the statute merely conferred rulemaking authority on the SEC.[131]

Further, it is important to remember that the rulemaking power that Congress grants to an administrative agency, like the

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126. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).

127. *See generally* 1 KENNETH CULP DAVIS & RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 3.1, at 107 (3d ed. 1994). "Every agency decision must be anchored in the language of one or more statutes the agency is charged to implement." *Id.*

128. *See* SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990). Section 10(b) and Rule 10b-5 use broad and vague terms and phrases such as "fraud," "deceit," "device, scheme or artifice," and "in connection with." *See* 15 U.S.C. § 78j(b) (1994); 17 C.F.R. § 240.10b-5 (1996).

129. Thel, *supra* note 12, at 425. According to Professor Thel, proponents of the 1934 Act consistently argued that the Act's goal was to control speculation and manipulation. *See id.*

130. 15 U.S.C. § 78j(b).

131. *See* S. REP. NO. 73-792, at 18 (1934), *reprinted in* 5 JACK S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES AND EXCHANGE ACT OF 1934, Item 17 (1973) (stating that section 10(b) "authorizes the Commission by rules and regulations to prohibit or regulate the use of any other manipulative or deceptive practices which it finds detrimental to the interests of the investor").

SEC, "charged with the administration of a federal statute is *not* the power to make law."[132] "Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute."[133]

Moreover, the language of section 10(b) itself does not give the SEC unfettered regulatory power but instead limits the Commission's rulemaking power.[134] Section 10(b) declares that a person's conduct is only unlawful if it involves a "manipulative or deceptive device or contrivance" used "in connection with" a securities transaction "in contravention of such rules" as the SEC promulgates.[135] Hence, it appears from the text of section 10(b) that an SEC-created rule based on the authority granted in section 10(b) must deal with manipulation and/or deception that is in connection with a securities transaction.[136]

Unfortunately, the sparse legislative history does not reveal the intended scope of section 10(b).[137] "The extensive hearings that preceded passage of the 1934 Act touched only briefly on § 10, and most of the discussion was devoted to . . . § 10(a)."[138] The original version of what would eventually become the 1934 Act, the Fletcher-Rayburn bill, underwent several revisions before Congress finally passed it, but two key additions to section 10(b) were the terms "manipulative" and "deceptive."[139] These

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132. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472-73 (1977) (emphasis added) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976)).

133. *Id.*

134. *See id.*

135. *See* Securities Exchange Act of 1934, Pub. L. No. 73-404, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78j); *see also* Thel, *supra* note 12, at 388.

136. Congress' use of these terms may even suggest "that it did not intend to reach insider trading." Brief for Appellant at 45, United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996) (94-3714). "In the context of securities markets, '[m]anipulation' is virtually a 'term of art' that 'refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.'" *Id.* (quoting *Santa Fe Indus., Inc.*, 430 U.S. at 476).

137. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976).

138. *Id.* According to one commentator

> section 10(b) was one of the least controversial parts of the 1934 Act . . . [that] went relatively unnoticed in the major battles over stock exchange regulation, margin rules and broker-dealer segregation, and the less violent struggles over manipulative pools, shortswing insider trading, registration and reporting requirements . . . and the creation of the SEC.

ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 2.2, at 331 (2d ed. 1995).

139. *See* Thel, *supra* note 12, at 426. With the exception of the establishment of the SEC, all of the important features of the 1934 Act trace back to the Fletcher-Rayburn bill. *See id.*

terms may have been added "to make it clear that the residual rulemaking authority eventually incorporated in section 10(b) should be read with reference to the rest of the [1934] Act."[140]

Further, as to the issue of whether Congress intended to grant absolute rulemaking authority, commentators argue that the terms "manipulative" and "deceptive" in section 10(b) suggest that Congress did not intend to do so.[141] Thomas Corcoran, a spokesperson for the drafters of the statute, stated that the purpose of section 10(b) was to "prevent manipulative devices," an objective with which no one appeared to have disagreed.[142] The language of section 10(b) evidences narrow congressional intent, which is also consistent with the scant legislative history.[143]

B. *Rule 10b-5 and Its Legislative History*

The SEC, pursuant to Congress' grant of rulemaking power found in section 10(b), promulgated Rule 10b-5. Rule 10b-5 makes it unlawful "[t]o 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."[144] The limiting language of section 10(b) suggests that the fraud or deceit required by Rule 10b-5 be confined within

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140. *Id.* at 452-53.

141. *See id.* at 454. "The most that can be said," according to Professor Thel, "is that 'deceptive' and 'manipulative' were both added to the section, not in an attempt to change its thrust, but to provide 'guidance to those who must determine which types of acts are reached by the statute.'" *Id.* (quoting Schreiber v. Burlington N., Inc., 472 U.S. 1, 8 (1985)).

142. *See Stock Exchange Regulation: Hearings Before House Comm. on Interstate and Foreign Commerce on HR 7852 and HR 8720*, 73d Cong. 115 (1934), *reprinted in* 7 ELLENBERGER & MAHAR, *supra* note 131, Item 23. One of the most frequently quoted explanations of the purpose of section 10(b) is the statement of Thomas G. Corcoran, a spokesman for the drafters of section 10(b), in a hearing on the original bill. Mr. Corcoran described the section as a catchall clause to prevent fraudulent securities transactions. He spoke of section 9(c) of the original bill, the section that became section 10(b): "Subsection (c) says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection (c) is a catch all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices." *Id.* Judge Adams of the Third Circuit seems to have the correct characterization of Mr. Corcoran's meaning: "It seems quite clear that [section 10(b)] was intended to be a 'catchall' only for 'any manipulative or deceptive device[s] or contrivance[s].'" Kohn v. American Metal Climax, Inc., 458 F.2d 255, 277 (3d Cir. 1972) (Adams, J., concurring and dissenting) (quoting text of Rule 10b-5). Mr. Corcoran's use of the term "manipulative devices" may even suggest that section 10(b) does not encompass insider trading. *See* Brief for Appellant at 45, United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996) (94-3714).

143. *See generally* Thel, *supra* note 12, at 460.

144. 17 C.F.R. § 240.10b-5 (1996) (emphasis added).

section 10(b) parameters of either manipulation or deception.[145] In other words, "fraud" under Rule 10b-5 cannot be construed more broadly than the section 10(b) strictures requiring deception.[146] In support of this proposition, the Supreme Court has said that the language of the statute lacks any "indication that Congress meant to prohibit any conduct not involving manipulation or deception."[147]

This position is buttressed by the SEC Release issued at the time the Commission adopted Rule 10b-5. The Release states that "[t]he new rule closes a loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud *in their purchase*."[148] And again in its 1942 annual report, the Commission declared that Rule 10b-5 was adopted as "additional protection *to investors*."[149] These SEC statements concerning Rule 10b-5 suggest that the Commission's intent was that the rule be used narrowly as an antifraud tool to protect investors, particularly those investors that are involved in a prohibited securities transaction.

Further, Rule 10b-5 appears to have been "a hastily drafted response to a situation clearly involving intentional misconduct" by a corporate insider.[150] The SEC adopted it after only cursory review and discussion in order to respond quickly to a situation that had not yet been addressed by the securities laws.[151] Thus,

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145. *See id.*; *see also* United States v. Bryan, 58 F.3d 933, 945-46 (4th Cir. 1995).

146. *See* United States v. O'Hagan, 92 F.3d 612, 615 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

147. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977).

148. SEC v. Clark, 915 F.2d 439, 450 n.21 (9th Cir. 1990) (quoting SEC Release No. 3230 (May 21, 1942) (emphasis added)).

149. *Id.* at 451 n.21 (quoting SEC, EIGHTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 10 (1942) (emphasis added)).

150. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 213 n.32 (1976).

151. Milton Freeman, a former SEC staff attorney, remembered Rule 10b-5's informal beginning:

> It was one day in the year 1943 [1942], I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders . . . and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled . . . . Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at section 10(b) and

in light of the scant legislative history with respect to section 10(b) and the conditions under which the Commission promulgated Rule 10b-5, it seems that for all practical purposes neither Congress nor the SEC even considered imposing liability so broadly as the misappropriation theory does.[152]

While the legislative history provides courts with little valuable insight as to the intended scope of section 10(b),[153] it does seem clear that Congress has provided the SEC with the rulemaking power that is necessary to protect investors. Moreover, this grant of power is limited in that such SEC-created rules must be based on "manipulative or deceptive devices" used or employed "in connection with" securities transactions.[154] So, although the language of Rule 10b-5 considered in isolation may lend support to the misappropriation theory, the language must be read as narrowed or constrained by the language of section 10(b)'s delegation of rule-making authority.

> I looked at section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.
>
> We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Conference on Codification of the Federal Securities Laws, 22 BUS. LAW. 793, 922 (1967). The SEC's response to the problem as described by Freeman was a broadly worded rule that has remained unchanged since its genesis in 1942.

152. As the Ninth Circuit appropriately stated in *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990), "it would be disingenuous to suggest that in 1942 the SEC sanctioned or even foresaw the use of the misappropriation theory." *Id.* at 451. In addition, a former SEC Commissioner has noted that "the fact that eight years elapsed between passage of [section 10(b)] in 1934 and adoption of [Rule 10b-5] in 1942 also suggests that the language of the statute did not compel a sweeping antifraud proscription of Rule 10b-5's scope." Joseph A. Grundfest, *Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority*, 107 HARV. L. REV. 963, 981 n.74 (1994). Professor Grundfest continued: "If a rule with such broad effect was so clearly contemplated or compelled by the statute, the Commission would not have waited eight years to act." *Id.*

153. In 1934, Congress did not anticipate the potential uses of section 10(b). *See generally* BROMBERG & LOWENFELS, *supra* note 138, at 331 (stating that little evidence of congressional intent existed because section 10(b) was one of the least controversial parts of the 1934 Act).

154. 15 U.S.C. § 78j(b) (1994).

C. *The Supreme Court's Standard for Rule 10b-5 Liability*

The Supreme Court has yet to determine whether the misappropriation theory is a valid means of imposing Rule 10b-5 liability. The Court skirted the issue in *Chiarella*, stating that the issue had not come before the jury in that case.[155] In addition, the Court was evenly divided on the validity of a conviction based on this theory in *Carpenter*.[156] Since *Carpenter*, the Court has had two opportunities[157] to review cases adopting the misappropriation theory, but declined to do so until the recent grant of the petition for a writ of certiorari to review the *O'Hagan* case.[158]

However, the Supreme Court has given lower courts guidance in this area. First, the Court has made plain that, with respect to the scope of conduct prohibited by section 10(b), it will refuse to allow imposition of Rule 10b-5 liability for acts that are not prohibited by the text of the statute.[159] Second, the Court in *Dirks* and *Chiarella* clearly articulated an insider-trading standard. The *Chiarella* and *Dirks* decisions brought "clarity and coherence" to insider-trading law; both decisions narrowly interpreted "insider trading" under section 10(b) and Rule

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155. *See* Chiarella v. United States, 445 U.S. 222, 235-36 (1980).

156. "An affirmance by an evenly divided court is 'not entitled to precedential weight.'" United States v. Chestman, 947 F.2d 551, 566 n.3 (2d Cir. 1991) (en banc) (quoting Neil v. Biggers, 409 U.S. 188, 192 (1972)). Accordingly, the Supreme Court's opposition or support for the theory remains unsettled. *See id.* In addition, the Ninth Circuit noted in *Clark* that "legal experts reacted quite differently to the Court's four-to-four deadlock on the question of whether the *Carpenter* defendants had committed securities fraud" under section 10(b) and Rule 10b-5. 915 F.2d at 446 n.11 (quoting Barbara Bader Aldave, *The Misappropriation Theory:* Carpenter *and Its Aftermath*, 49 OHIO ST. L.J. 373, 374 (1988)). One member of the SEC argued that the Supreme Court's decision kept the misappropriation theory "alive and well." *See id.* On the other hand, at least one law professor believed that *Carpenter* evidenced "pretty strongly" that the misappropriation theory was a "fairly dubious proposition." *See id.*

157. *See Chestman*, 947 F.2d at 551; SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991).

158. United States v. O'Hagan, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

159. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 173 (1994); *Chiarella*, 445 U.S. at 226; Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976); *see also Central Bank*, 511 U.S. at 175 ("Our consideration of statutory duties, especially in cases interpreting § 10(b), establishes that the statutory text controls the definition of conduct covered by § 10(b).").

10b-5.[160] Disregard for the Court's narrow standard has only resulted in confusion and inconsistency.[161]

1. The narrow scope of section 10(b) and Rule 10b-5

The *O'Hagan* court properly maintained the narrow scope established by the Supreme Court for section 10(b) and Rule 10b-5. The Supreme Court in *Santa Fe* clarified that section 10(b) and Rule 10b-5 must be construed narrowly.[162] The Court explained that Rule 10b-5 can be interpreted no more broadly than section 10(b), the section it purports to interpret.[163] The Supreme Court adhered to that principle in *Central Bank* even when it meant upsetting decades of precedent.[164] Not only has the Supreme Court insisted that Rule 10b-5 be integrated within the limits of section 10(b), but the Court has also established a narrow scope for section 10(b). The Court has stated that "[w]hen a statute speaks so specifically in terms of manipulation and deception, . . . and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute."[165] Indeed, although section 10(b) has commonly been referred to as the "catchall" provision, the Court has maintained that "what [section 10(b)] catches must be fraud."[166]

The Supreme Court has stated that "not every instance of financial unfairness constitutes fraudulent activity" under section 10(b).[167] The Court likewise made clear that "'not all breaches of fiduciary duty in connection with a securities transac-

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160. *See* JONATHAN R. MACEY, INSIDER TRADING, ECONOMICS, POLITICS, AND POLICY 1 (1991).

161. *See id.* Macey stated that the "much-needed shift from decades of incoherence and confusion came as the Court, for the first time, recognized the crucial link between the legal obligation to refrain from insider trading and the traditional fiduciary duties that corporate officers and directors owe to their shareholders." *Id.* Macey added that *Chiarella* and *Dirks* "were as concise, coherent, and economically rational as judge-made law can be." *Id.* at 67.

162. *See Santa Fe Indus., Inc.*, 430 U.S. at 472-74.

163. *See id.*

164. *See Central Bank*, 511 U.S. 164. The Court in *Central Bank* remained faithful to the text of section 10(b) in reversing years of precedent in the federal courts and held that plaintiffs do not have a private right of action for aiding and abetting violations of section 10(b). *See id.*

165. *See Santa Fe Indus., Inc.*, 430 U.S. at 473 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976)).

166. Chiarella v. United States, 445 U.S. 222, 234-35 (1980).

167. *Id.* at 232; *see also Santa Fe Indus., Inc.*, 430 U.S. at 474-77.

tion'" come within the purview of the Rule.[168] The breach must be accompanied by "'manipulation or deception.'"[169] The Supreme Court has explained that "deception" for purposes of section 10(b) consists only of making a material misstatement or omission in violation of a duty to disclose.[170] Further, in *Dirks* the Court stated that a "violation [of section 10(b)] may be found only where there is 'intentional or willful conduct designed to *deceive or defraud investors.*'"[171]

2. *The Supreme Court's insider-trading standard*

The Supreme Court outlined in *Chiarella* and later refined in *Dirks* the requisites for finding Rule 10b-5 insider-trading liability.[172] A person "will be liable under Rule 10b-5 for insider trading only where he fails to disclose material, nonpublic information before trading" when he has an affirmative duty to the corporation whose securities are traded.[173] This duty is essential to the "in connection with" requirement of both the statute and the rule, as well as the "deception" element of section 10(b) and the "fraud" element of Rule 10b-5.[174]

In order to satisfy the "in connection with" requirement of section 10(b) and Rule 10b-5, a duty to disclose must be owed to the corporation, or at least the parties to the transaction; this duty does not arise from the "mere possession of nonpublic market information."[175] The duty arises from "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of

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168. *See* Dirks v. SEC, 463 U.S. 646, 654 (1983) (quoting *Santa Fe Indus., Inc.*, 430 U.S. at 472).

169. *Id.* (quoting *Santa Fe Indus., Inc.*, 430 U.S. at 473).

170. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 177 (1994) (stating that "[a]s in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act"). The Court stated in *Santa Fe Industries, Inc.* that "deception" under section 10(b) does not encompass "breaches of fiduciary duty . . . without any charge of manipulation or lack of disclosure." 430 U.S. at 470. The Court has also noted that it "cannot amend [section 10(b)] to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute." *Central Bank*, 511 U.S. at 177-78.

171. *Dirks*, 463 U.S. at 663 n.23 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976) (emphasis added)).

172. *See Dirks*, 463 U.S. 646; Chiarella v. United States, 445 U.S. 222 (1980).

173. *Dirks*, 463 U.S. at 654; *see also Chiarella*, 445 U.S. at 227-28.

174. *See* MACEY, *supra* note 160, at 53.

175. *Chiarella*, 445 U.S. at 235.

allowing a *corporate insider* to take advantage of that information by trading without disclosure."[176]

The trader must be a "corporate insider" who owes a fiduciary duty to the shareholders of her corporation, she must have access to inside corporate information, and she must have traded in the corporation's securities.[177] The Supreme Court in *Chiarella* emphasized the necessity of finding a specific relationship between the parties to the transaction as a precondition to Rule 10b-5 liability.[178] The Court, later reaffirming this notion in *Dirks*, declared that "[n]ot to require such a fiduciary relationship . . . would 'depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties' and would amount to 'recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.'"[179]

The Supreme Court in *Chiarella* rejected the notion that the duty to disclose material facts is owed to the trading markets in general.[180] Thus, a person who is not the corporation's agent, fiduciary, or a person in whom the sellers of the securities had a relationship of trust and confidence, but is, in fact, a complete stranger to the market participants and deals with them only through impersonal market transactions, cannot be liable under section 10(b) according to the Supreme Court.[181] This approach is also consistent with the Court's admonitions in *Chiarella*, *Dirks*, and *Central Bank* that the principal concern of section 10(b) is to protect purchasers and sellers of securities.[182]

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176. *Id.* at 227 (emphasis added).

177. *See id.* at 227-28, 232-33.

178. *See id.* at 227-28.

179. Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (quoting *Chiarella*, 445 U.S. at 232-33).

180. *See* Moss v. Morgan Stanley Inc., 719 F.2d 5, 16 (2d Cir. 1983) (paraphrasing *Chiarella*, 445 U.S. at 233).

181. *See Dirks*, 463 U.S. at 654; *Chiarella*, 445 U.S. at 232-33.

182. *See* United States v. Bryan, 58 F.3d 933, 946-47 (4th Cir. 1995) (discussing the *Chiarella*, *Dirks*, and *Central Bank* decisions).

D. Attempts to Reconcile the Misappropriation Theory with the Text of Section 10(b), Rule 10b-5, and Supreme Court Precedent

1. Chief Justice Burger's arguments in favor of a broad reading and a need to ensure fairness

The arguments of the proponents of the misappropriation theory find their genesis in *Chiarella's* dissent.[183] Chief Justice Burger, in his dissenting opinion, argued that the language of section 10(b) was broad enough to allow the Court to impose liability on a person who misappropriates nonpublic information.[184] The Burger argument was based on (1) the notion that Congress in enacting section 10(b) was really trying to ensure fairness and (2) that the misappropriation theory is merely a natural extension of the *Cady, Roberts & Co.* duty.[185]

The language of the statute and the rule may indeed be broad. The Fourth Circuit, in *United States v. Bryan*, recognized that section 10(b) may be broad and "[a]bsent guidance from the

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183. *See Chiarella*, 445 U.S. at 239-45. Potentially, footnote 14 in the *Dirks* opinion could be used to support the misappropriation theory as well. *See Dirks*, 463 U.S. at 655 n.14. The Court in *Dirks* noted that "[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant *working for the corporation*, these outsiders may become fiduciaries of the shareholders." *Id.* (emphasis added). However, the footnote in *Dirks* remains consistent with the traditional theory of liability under Rule 10b-5. Only those individuals with a specific relationship to the corporation and its shareholders will be liable, and only then if they trade in the securities of the corporation to whom they owe this duty.

184. *See Chiarella*, 445 U.S. at 240-41 (Burger, C.J., dissenting). The Chief Justice argued that "[t]he very language of § 10(b) and Rule 10b-5 'by repeated use of the word "any" [was] obviously meant to be inclusive'" *Id.* at 241 (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).

185. *See id.* According to Chief Justice Burger, the misappropriation theory "follows naturally from legal principles enunciated by the [SEC] in its seminal *Cady, Roberts* decision." *Id.*; *see also supra* notes 28-33 and accompanying text. Yet, while the misappropriation theory is indeed an extension of the *Cady, Roberts & Co.* duty, it is an unnatural one that is not supported by Supreme Court precedent. When the Supreme Court discussed the *Cady, Roberts & Co.* duty, it emphasized the duty of a *corporate insider*; the Court did not extend Rule 10b-5 liability beyond a breach of duty owed to either the corporation whose shares are traded or a party to the securities transaction. *See Chiarella*, 445 U.S. at 226-30. The SEC in *Cady, Roberts & Co.* found a broker-dealer liable as an insider because he was acting as an agent of the company in whose shares he traded. *See* Cady, Roberts & Co., 40 S.E.C. 907 (1961). The broker-dealer had possessed material, nonpublic information and had breached a fiduciary duty to the shareholders of the corporation in whose shares he traded. *See id.* at 907-08. The misappropriation theory would allow extending a similar finding to a person who owes neither a duty to the shareholders of the corporation in whose shares he trades nor a duty to anyone else involved in the securities transaction itself. *See* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc).

Supreme Court, the [statute] could plausibly accommodate the misappropriation theory."[186] However, the Supreme Court has provided the lower courts guidance in this area. When addressing section 10(b) and Rule 10b-5, the court has consistently narrowed the scope of liability.[187] The misappropriation theory steps beyond the lines that the Supreme Court has drawn for the lower courts. Thus, despite the Court's emphasis on a narrow interpretation, the misappropriation theory has been used to interpret Rule 10b-5 liability broadly.

Further, the "common theme" of the misappropriation-based cases, as one commentator suggested, seems to be "that it is unfair to allow people to [trade in] securities based on information that they either acquired under questionable circumstances or received entirely appropriately" but without authorization to use for personal gain.[188] Certainly, Mr. O'Hagan's conduct in this case seems to be unfair and questionable. Yet, while this type of conduct may appear to be unfair, the lack of legislative history suggests that neither Congress nor the SEC intended to create equality in the securities markets; the aim was to protect investors by eliminating abusive speculation.[189] Further, the Supreme Court in *Chiarella* emphasized that although the statute and the rule are designed to protect investors against fraud, they do not remedy every instance of undesirable conduct involving securities.[190]

2. The misappropriation connection between section 10(b) "deception" and Rule 10b-5 "fraud"

The misappropriation theory appears in two forms: (1) wrongful acquisition of information should create a duty on the part of the acquiror to disclose the information before trading[191] and (2) Rule 10b-5 fraud is present when the individual misap-

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186. *Bryan*, 58 F.3d at 945.

187. *See, e.g.*, Central Bank v. First Interstate Bank, 511 U.S. 164 (1994); Dirks v. SEC, 463 U.S. 646 (1983); *Chiarella*, 445 U.S. 222; Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

188. Kenny & Thebaut, *supra* note 67, at 144.

189. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

190. *See Chiarella*, 445 U.S. at 232.

191. This form of the misappropriation theory was first conceived by W. Page Keeton and relied on by Chief Justice Burger in his dissenting opinion in *Chiarella*. *See* W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936); *see also Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting). This form incorporates the notion that the misappropriation of confidential information automatically creates the duty to disclose the information before trading.

propriates or misuses confidential information, and the fraud is "in connection with" a securities transaction in which the misappropriation is motivated by a desire to trade.[192] Both forms involve a tenuous link between the two key elements of Rule 10b-5 liability, namely, the "deception" required by section 10(b) and Rule 10b-5 and the "in connection with" a securities transaction requirement.

The logic seems to be the amalgamation of two separate and independent acts—the misappropriation of confidential information and the use of that information in a securities transaction. The misappropriation generally takes place in the context of an employee stealing his employer's material information. The fraud is deemed to take place during the misappropriation of such information, which is itself considered deceptive for purposes of section 10(b). Thus, if the misappropriation is prompted by the desire to use the confidential information in a securities transaction, the fraud is then deemed to have taken place "in connection with" the transaction.[193] In the scenario above, the first and second acts are two somewhat related, but separate, acts.[194] The misappropriation theory would have the courts combine the second act, involving the purchase or sale of securities, with the first because of the perpetrator's intent to use the stolen information in the securities transaction.

The scenario above effectively reveals the major problem with the misappropriation theory in its failure to require section 10(b) "deception." The theory does not require a material misrepresentation or nondisclosure of material information in violation of a duty to disclose.[195] The Supreme Court in *Santa Fe Industries, Inc.* recognized the lower court's characterization of "misrepresentation" as a "misstatement," and "nondisclosure" as

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192. This form has been used by the Second Circuit cases following Chief Justice Burger's dissent in *Chiarella*. *See* United States v. Carpenter, 791 F.2d 1024, 1027-34 (2d Cir. 1986); SEC v. Materia, 745 F.2d 197, 201-04 (2d Cir. 1984); United States v. Newman, 664 F.2d 12, 15-19 (2d Cir. 1981).

193. *See supra* note 192.

194. Note that these two acts are only related if the misappropriator commits both acts. If the person were to steal material corporate information but not use such information in a securities transaction there presumably would be no violation.

195. *See* United States v. Bryan, 58 F.3d 933, 949 & nn.13-14 (4th Cir. 1995). The court recognized that "the misappropriation of information in breach of a fiduciary duty may, in a generalized sense, involve deception, [but] in most cases . . . will not constitute a 'misrepresentation' or 'nondisclosure.'" *Id.* at 949 (footnote omitted).

"omission."[196] The misappropriation theory, however, does not require either a misstatement or an omission.[197] The theory instead seems to misappropriate Supreme Court precedent, disregarding the Court's interpretation of the statutory requirement of deception.

In essence, the misappropriation theory allows the courts to find that an individual's wrongful conduct with respect to one party, wholly unrelated to the securities transaction, justifies Rule 10b-5 liability. Under this theory, it appears that the only wrong is the one with respect to the owner of the misappropriated information—the source. The theory seems to rest on the assumption that it is deceptive and fraudulent to securities investors for a person to *misuse*, for personal gain, information that has been entrusted to the trader. The basic principle on which many of the misappropriation-based cases rest is that an employee's breach of the duty of confidentiality to the employer constitutes the fraud necessary for a Rule 10b-5 violation.[198] Yet the Supreme Court has maintained that not every breach of fiduciary duty will suffice for the requisite fraud under Rule 10b-5 liability.[199]

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196. Santa Fe Indus., Inc. v. Green, 430 U.S. 467, 474 (1977); *see also supra* note 170 and accompanying text.

197. *See Bryan*, 58 F.3d at 949.

198. *See, e.g.*, SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991) (explaining that a person violates Rule 10b-5 and section 10(b) by misappropriating and trading on material information entrusted to him by virtue of a fiduciary relationship such as employment); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990) (stating that an employee's knowing misappropriation and use of employer's material, nonpublic information regarding intention to acquire another firm was a violation of section 10(b) and Rule 10b-5); United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986) (finding that the 1934 Act prohibited employee's misappropriation of financial newspapers forthcoming publication schedule to purchase and sell securities to be discussed in future columns); United States v. Newman, 664 F.2d 12 (2d Cir. 1981) (holding that conduct of a securities trader and his confederates who purchased stock in companies that were merger and takeover targets of clients of investment banking firms based on information obtained by employees of those firms, could be found to constitute criminal violation of the 1934 Act and Rule 10b-5).

199. *See* Dirks v. SEC, 463 U.S. 646, 654 (1983). In addition, an employee's duty to his employer is different than the duty of a corporate insider to shareholders of his corporation—the former has nothing to do with a duty to speak. Rather, it is a duty to refrain from using confidential information entrusted to him by his employer. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968). Disclosure by the employee would aggravate the breach of duty to the employer, not cure it. Besides, to suggest, as the misappropriation theory does, that a mere breach of a fiduciary duty is a violation of Rule 10b-5 squarely conflicts with the Supreme Court's holding in *Santa Fe Industries, Inc. See* 430 U.S. at 462.

The misappropriation theory confuses theft with section 10(b) deception and Rule 10b-5 fraud. Such a standard attempts to create a logical relationship between the act of misappropriating confidential information and a Rule 10b-5 duty; the two, however, simply are not closely related. While the theft of information from its source can be unethical and unfair, such theft does not constitute either fraud or deceit for Rule 10b-5 purposes *unless* it involves a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose.[200] Moreover, as one commentator has observed, "[t]he most obvious problem with the misappropriation theory is that when material, nonpublic information is obtained *without a breach of duty*, there is no obligation to disclose or refrain from trading."[201]

While the Supreme Court has required an insider to have an affirmative duty to the corporation whose securities are traded, the misappropriation theory does not require such a duty.[202] Indeed, the breach of nearly any fiduciary duty will suffice under the theory.[203] The Court, however, specifically stated in *Chiarella* that "there can be no duty to disclose where the person who has traded on inside information 'was not [the corporation's] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.'"[204] The misappropriation theory clearly falls outside the explicit boundaries set by the Court by imposing liability regardless of whether the trader is the corporation's agent, a fiduciary, or even a person in whom the sellers place their trust.

The Second Circuit, in *Chestman*, has recognized that its misappropriation theory directly conflicts with the Supreme Court's standard for Rule 10b-5 liability and is not fastened to shareholder relations, but rather extends to any fiduciary obliga-

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200. *See* Central Bank v. First Interstate Bank, 511 U.S. 164, 177 (1994); *Santa Fe Indus., Inc.*, 430 U.S. at 470-76.

201. John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1136 (1996). Beeson argues that the misappropriation theory "violates basic tenets of justice that identical actions, performed with the same level of culpability, would be treated differently by the law." *Id.* at 1137.

202. *See Clark*, 915 F.2d at 443.

203. *See* United States v. O'Hagan, 92 F.3d 612, 617 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842); United States v. Bryan, 58 F.3d 933, 949 (4th Cir. 1995). *See generally* United States v. Chestman, 947 F.2d 551, 565-66 (2d Cir. 1991) (en banc).

204. *Dirks*, 463 U.S. at 654 (quoting Chiarella v. United States, 445 U.S. 222, 232 (1980)).

tions.[205] The *Chestman* court stated that the fiduciary obligations established in *Chiarella* and *Dirks* are "[t]ethered to the field of shareholder relations" and "arise within a narrow, *principled sphere*," whereas "[t]he existence of fiduciary duties in other common law settings is anything but clear."[206] The misappropriation theory expands the scope of liability to scrutinize relationships unrelated to the securities transaction, but, as the Supreme Court explained in *Chiarella*, that Rule 10b-5 "liability is premised upon a duty to disclose arising from a relationship of trust and confidence between *parties to a transaction*."[207]

3. *The "touch" test*

Those courts which have adopted the misappropriation theory have reconciled it with the requirement that deception occur "in connection with" the purchase or sale of any security by concluding that the deception need only "touch" a securities transaction.[208] The Second Circuit took this notion from obscure language in the Supreme Court's decision in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[209] In *Newman*, the Second Circuit used this "broad" test to rationalize that "since [the] sole purpose in participating in the misappropriation of confidential . . . information [is] to purchase [securities]," there is fraud in connection with the transaction.[210]

However, the Supreme Court has made it plain, particularly in *Dirks* and *Chiarella*, that the fraud must do more than "touch" the transaction.[211] An isolated passage that was written years before *Dirks* and *Chiarella* cannot fairly be read to eliminate the Court's standard of requiring fraud on a party to the securities

205. *See Chestman*, 947 F.2d at 567.

206. *Id.* (emphasis added).

207. *Chiarella*, 445 U.S. at 230 (emphasis added).

208. *See* SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984); United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981).

209. 404 U.S. 6, 12-13 (1971) ("Manhattan suffered an injury as a result of deceptive practices touching its sale of securities as an investor."). *See, e.g.*, SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990) (requiring only that "the fraud must somehow 'touch' upon securities transactions"); *Newman*, 664 F.2d at 18 (finding that the 1934 Act requires merely that the fraud "touch" the securities transaction).

210. *Newman*, 664 F.2d at 18.

211. *See* Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (explaining that the duty to disclose or abstain arises from a specific relationship between two parties to the transaction); *Chiarella*, 445 U.S. at 227-31 (explaining that an insider must have duty to either shareholders of a corporation whose shares are traded or to a party to the particular transaction).

transaction.[212] The *O'Hagan* court correctly rejected the touch test on this basis.

The touch test's requirement of a superficial connection with a securities transaction reflects the most distressing problem with the misappropriation theory that, in spite of Supreme Court precedent, it "does not require that the buyer or seller of securities be defrauded."[213] In other words, the fraud that the misappropriation theory captures is not "deception" that is "in connection with" the securities transaction. Commentators have observed that the misappropriation theory, "while claiming to adhere to a strict interpretation of common-law fraud which requires a relationship between the parties[,] . . . abandons the common law in allowing a breach of duty owed to some other person to serve as the basis of the violation."[214]

In addition, the language of both section 10(b) and Rule 10b-5 indicates that liability can reach "only deception of persons with some connection to, or some interest or stake in, an actual or proposed purchase or sale of securities."[215] Again, the misappropriation theory focuses on whether the trader breached a duty to the party *from* whom the information was obtained—the source.[216] The pertinent breach is not to a party on the opposite side of the transaction. There is no concern as to whether *an actual party* to the securities transaction is defrauded.[217] The misappropriation theory transforms section 10(b) "'from a rule intended to govern and protect relations among market participants' into an expansive 'general fraud-on-the-source theory.'"[218] The *O'Hagan* court appropriately rejected the misappropriation theory because it imposes section 10(b) liability even though no participant to the transaction is deceived or defrauded.

While proponents of the misappropriation theory contend that it is merely a logical and natural extension of the classical theory of insider-trading liability under section 10(b) and Rule

212. This is true particularly in light of the fact that the victim of fraud in *Bankers Life & Casualty Co.* was an actual party to the transaction; he was a seller of securities, who was injured "as an investor." *See Bankers Life & Cas. Co.*, 404 U.S. at 10.

213. United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc).

214. Beeson, *supra* note 201, at 1138.

215. United States v. Bryan, 58 F.3d 933, 949-50 (4th Cir. 1995).

216. *See Chestman*, 947 F.2d at 566.

217. *See id.*

218. United States v. O'Hagan, 92 F.3d 612, 619 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842) (quoting *Bryan*, 58 F.3d at 950).

10b-5 and that such an extension is necessary to ensure fairness, the text of the statute and the rule, coupled with Supreme Court precedent, simply do not support such a broad expansion of the scope of liability.

E. Policy Considerations and the Need for Reform

In addition to the legal considerations of Rule 10b-5 and the misappropriation theory of liability, there are important policy concerns that must be addressed. This Part will discuss the concerns of predictability and the need for guiding principles and suggest a way to deal with the apparent gap in Rule 10b-5 liability—the situation involving tender offers.

1. Certainty and predictability—a guiding principle

The Supreme Court stated recently, in *Central Bank*, that the securities industry generally, and section 10(b) specifically, is "'an area that demands certainty and predictability,'" and "decisions 'made on an ad hoc basis, offering little predictive value' to those who provide services to participants in the securities business" must be avoided.[219] The use of the misappropriation theory has caused confusion in the securities industry resulting in everything but certainty and predictability. The various circuits' ad hoc basis of application of the theory has been "inconsistent and unpredictable," which could "subject[] individuals to liability on the basis of a shifting theory [and] would be unfair."[220] The misappropriation theory inadequately places investors on notice and creates too much uncertainty.[221] The use of section 10(b) and Rule 10b-5 to prosecute securities traders like Mr. O'Hagan violates constitutional fair notice principles.

In addition, the Supreme Court in *Dirks* stated that "it is essential . . . to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's insider-trading rules."[222] The misappropriation theory therefore fails an essential role of the securities laws: to provide "a guiding princi-

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219. Central Bank v. First Interstate Bank, 511 U.S. 164, 188 (1994) (quoting Pinter v. Dahl, 486 U.S. 622, 652 (1988)).

220. Timothy J. Horman, *In Defense of* United States v. Bryan*: Why the Misappropriation Theory is Indefensible*, 64 FORDHAM L. REV. 2455, 2503 (1996).

221. *See* Beeson, *supra* note 201, at 1143.

222. Dirks v. SEC, 463 U.S. 646, 664 (1983). The Court in *Dirks* noted 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." *Id.* at n.24.

ple."[223] The theory makes it nearly impossible for lawyers to advise clients as to the parameters of conduct allowed under the statute and rule.[224]

2. *The protection of purchasers and sellers*

The premise of the Supreme Court's holdings in *Chiarella*, *Dirks*, and, more recently, *Central Bank*, was that the principal concern of section 10(b) is the protection of purchasers and sellers of securities.[225] If this is true, the misappropriation theory does not satisfy that concern because the theory imposes liability regardless of whether an actual purchaser or seller involved in the particular securities transaction is defrauded or even harmed in some way.[226] As a result, the theory "requires the SEC to police intrafirm corporate contracts under the guise of policing the securities markets."[227]

3. *Alternative means to address the misappropriation problems*

While proponents of the misappropriation theory argue that its use is necessary to contend with insider trading, ample means exist to allow those persons who have been injured by insider trading to seek redress in court. Further, "[m]uch of the conduct rendered criminal under the misappropriation theory is already criminalized under § 10(b) as interpreted in *Chiarella* and *Dirks*, or under the mail and wire fraud statutes."[228] The Second Circuit acknowledged in *Chestman* that conduct on which early misappropriation convictions were based would now likely be reached without the misappropriation theory.[229] Liability under state law antifraud provisions should provide ample ammunition in this area as well. Finally, liability for breaches of em-

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223. *See generally* Horman, *supra* note 220, at 2502-05 (1996) (discussing the Second Circuit's inconsistent and unpredictable application of the misappropriation theory).

224. This argument may seem to be an excuse. However, Rule 10b-5 imposes serious criminal penalties which merit a demand for guidance.

225. *See* United States v. Bryan, 58 F.3d 933, 946-47 (4th Cir. 1995).

226. *See* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc).

227. MACEY, *supra* note 160, at 63.

228. *Bryan*, 58 F.3d at 953. However, this fact may create an imbalance in criminal and civil enforcement of the federal securities laws. In a case involving "outsider" trading, it may be easier for the government to obtain a criminal conviction in the Eigth Circuit for one of the alternative provisions (such as the mail or wire fraud provisions) than it is for the SEC to obtain civil equitable relief.

229. *See Chestman*, 947 F.2d at 566.

ployment contracts, burglary, negligence, misappropriation of confidential employment information, and theft should cover any remaining exposed areas for those parties whose valuable confidential information has been misappropriated or misused.

4. *Congress or the SEC should act in order to fill the gap involving tender offers*

It is true, however, that there are still individuals who, due to their misappropriation, or rather their misuse, of confidential information in advance of tender offers are able to amass monstrous profits in securities trading and yet avoid liability under Rule 10b-5 because they owe no duty to the target corporation or its shareholders.[230] In this respect, the *O'Hagan* decision is inadequate, especially in light of the fact that Mr. O'Hagan's conduct appears to be unethical.[231] In light of this fact, *O'Hagan* demonstrates the need for Congress to craft a statutory definition of insider trading.

If Congress or the SEC determine that unethical conduct, like that of Mr. O'Hagan, should be criminalized under the securities laws, they could resolve the issue by establishing a clear rule defining the types of securities trading that are impermissible.[232] Congress, in passing the Insider Trading Sanc-

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230. This is particularly the case in the context of mergers and acquisitions. *See, e.g.*, SEC v. Tome, 638 F. Supp. 596, 619 (S.D.N.Y. 1986) (noting opportunities for "insiders of a tender offer" to profit from trades preceding mergers and aquisitions).

231. O'Hagan may have abused his knowledge of the pending tender offer to garner huge profits. *See* United States v. O'Hagan, 92 F.3d 612, 614 (8th Cir. 1996) (rehearing and suggestion for rehearing en banc denied), *cert. granted*, 65 U.S.L.W. 3505 (U.S. Jan. 17, 1997) (No. 96-842).

232. *See* Beeson, *supra* note 201, at 1143. Beeson argues that the aim of the misappropriation theory is justified but "insufficiently" defined to "place law-abiding investors on notice." *Id.* Beeson suggests that a new SEC rule would be especially useful where "a traditional corporate fiduciary relationship is absent." *Id.* Providing "a bright-line rule that gives traders adequate notice," Beeson believes, "will promote the free flow of information to the market and will continue to provide incentives for analysts." *Id.* at 1148.

In 1992, one commentator declared:

> How should the SEC celebrate the anniversary of [Rule 10b-5,] its most famous piece of handiwork? I have a suggestion: The agency should repeal it. . . . [Fifty] years of erratic interpretation by the courts have made it an unworkable tool with which to achieve any legitimate objective of federal securities law.
>
> . . . .
>
> . . . The time has come to wipe the slate clean and start over.

David Cowan Bayne, S.J., *The Insider's Natural Law Duty:* Chestman *and the 'Misappropriation Theory'*, 43 U. KAN. L. REV. 79, 79 (1994) (quoting David L. Ratner,

tions Act of 1984[233] and the Insider Trading and Securities Fraud Enforcement Act of 1988,[234] has shown its ability to amend the securities laws. It would be unwise to merely codify the misappropriation theory, however, because it tends to concentrate on mere possession of confidential information and on a breach of duty to employers, "a concern that is unrelated to the goal of protecting investors."[235] Hence, codifying the misappropriation theory would fail to protect investors from the perceived evils of insider trading.[236]

If the SEC, a powerful government agency, wants to prosecute outsider traders like Mr. O'Hagan, it should seek congressional action. Yet if Congress is unwilling to develop a clear rule for the courts to apply, the Commission could alone resolve the confusion by promulgating a rule under section 10(b) authority.[237] The SEC would still be bound, however, by the language of section 10(b) to make rules that are tied to "manipulative or deceptive devices or contrivances" that are used "in connection with the purchase or sale of securities."

Until Congress or the Commission is willing to articulate a better standard by which to punish truly abusive insider trading, the courts are bound by the prohibitions found in the statute and its SEC-created counterpart.[238] The proscriptions of section 10(b)

It's Time to Repeal SEC's Rule 10b-5, TEX. LAW., June 1, 1992, at 20).

233. Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended at 15 U.S.C. §§ 78c, 78o, 78t, 78u, 78ff (1994)).

234. Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended at 15 U.S.C. § 78u-1).

235. Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 98-99 (1984). The concern of employers has no relevance to the federal securities laws in this respect, assuming they are not parties to the specific securities transactions involving the fraud.

236. *See id.* at 99. Mr. Phillips and Mr. Zutz suggest that Congress should enact legislation that would focus on protecting investors from persons who trade based on unfair information advantages: "[L]iability would require a showing that the trader acquired material, nonpublic information through a business . . . or other special relationship, and used that information for an improper purpose." *Id.* This approach appears feasible because it would clearly attach the perceived root of the problem and yet still allow financial analysts the freedom to use the information they legally obtain in connection with their business activities.

237. Congress has given the SEC the authority to promulgate such a rule pursuant to section 10(b). *See* 15 U.S.C. § 78j(b).

238. The court in *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), explained the dilemma that courts find themselves in when confronted with an inequitable result:

> Our rejection of the misappropriation theory certainly should not be taken as approval of the kind of conduct of which Bryan was convicted, nor should it be perceived as evidencing a view that such conduct is not properly the subject of criminal liability. Indeed, we understand the temptation to give

and Rule 10b-5, as the Supreme Court have interpreted them, do not encompass the broad-based notion of the misappropriation theory.

V. CONCLUSION

In cases like *United States v. O'Hagan*, it is tempting for courts to use the misappropriation theory to broaden the scope of liability in order to reach conduct that one's intuition may suggest is improper. While the Eighth Circuit was certainly faced with this temptation, it properly kept itself within the bounds set by the Supreme Court. Over the past two decades, the Court has maintained a narrow reading of section 10(b) and Rule 10b-5. In addition, the Supreme Court has set the standard for Rule 10b-5 insider-trading liability. The requirements are straightforward and concise: a corporate insider—one who owes a fiduciary duty to shareholders of the corporation whose securities are traded or to a party to the particular transaction—violates Rule 10b-5 when he buys or sells securities on the basis of material, nonpublic information. The Eighth Circuit applied the Supreme Court's insider-trading standard and appropriately rejected the misappropriation theory.

However, without statutory or regulatory reform, traders like Mr. O'Hagan will be able to profit from questionable conduct involving confidential information that they use in securities transactions in advance of tender offers. Congress or the SEC has the power to address such conduct and should do so in a way that would finally eliminate the confusion that currently exists. Yet, until such time as Congress resolves the problem, the Supreme Court must address the theory directly in order to restore consistency to insider-trading law under section 10(b) and Rule 10b-5. The Supreme Court should throw the third strike to the misappropriation theory of Rule 10b-5 liability.

Shawn J. Lindquist

> "legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair," by abandoning "distinctions premised on the source of the information [in favor of] the prophylactic intent of the securities laws." But in securities law, as in all areas of the law, our perceptions of what is wise or fair are ultimately of no relevance. In the end, we, as judges, no less than anyone else, are bound by the actual prohibitions enacted by Congress.

Id. at 959 (citations omitted) (quoting United States v. Carpenter, 791 F.2d 1024, 1029 (2d Cir. 1986)).