# THE UNEASY DOCTRINAL COMPROMISE OF THE MISAPPROPRIATION THEORY OF INSIDER TRADING LIABILITY

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## INTRODUCTION

Between 1973 and 1978, James Newman, a New York securities trader, participated in a scheme for which he later found himself in a considerable amount of trouble.[1] During that time, his co-conspirator Jacques Courtois was employed at an investment bank, where he frequently received advance information about upcoming mergers and acquisitions. He would pass this information on to Newman, who would then purchase stock in the target companies prior to the announcement of the takeover. Upon announcement, the stock price of the targets invariably rose and the two would split the profits.[2] Their scheme came to an abrupt end, however, when both were indicted for insider trading violations.[3]

In the earliest era of insider trading enforcement in the courts, the outcome of the case would have been a simple matter to predict.

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1 See United States v. Newman, 664 F.2d 12, 15 (2d Cir. 1981); see also infra notes 98-100 and accompanying text (discussing disposition of *Newman* in greater detail).

2 See *Newman,* 664 F.2d at 15.

3 See id. at 14-15. Neither Congress nor the courts has defined insider trading in express terms. Because of the complicated statutory and common law rules implicated in the regulation of such conduct, many of which are discussed in this Note, the term does not lend itself to easy definition. One commentator states that "insider trading is generally used to describe trading in securities on the basis of material nonpublic information about the securities themselves, the issuer of the securities, or the market for the securities." Jill E. Fisch, Start Making Sense: An Analysis and Proposal for Insider Trading Regulation, 26 Ga. L. Rev. 179, 179 n.2 (1991). This definition is, in reality, too broad, because not all trading on the basis of nonpublic information constitutes insider trading. The trading must constitute a breach of a fiduciary duty owed to the party with whom the wrongdoer trades, or, under the misappropriation theory, owed to the source of the information. See generally infra Parts I.B.2 & II (discussing fiduciary duty and misappropriation models of insider trading liability, respectively). Perhaps a more accurate definition is offered by Professor Langevoort, who designates insider trading as "*unlawful* trading in securities by persons who possess material nonpublic information about the company whose shares are traded or the market for its shares." Donald C. Langevoort, Insider Trading Regulation 5 (1991 ed.) (emphasis added). This definition begs the question, of course: What sort of trading on inside information is "unlawful"?

The "equal access" theory of liability, which prevailed in the federal courts prior to 1980,[4] imposed a broad, prophylactic rule in the securities markets requiring that parties on either side of a transaction have an equal ability to access all the material information the opposite party possesses.[5] If a trader possesses information that others cannot legally obtain on their own, trading on the basis of that information is unlawful. Because the parties with whom Newman traded could not have discovered the takeover information on their own, he would have been guilty of securities fraud.

In 1980, however, the Supreme Court developed another theory of insider trading liability which came to be known as the "fiduciary duty" model.[6] On this account, trading constitutes securities fraud only if the insider trades in breach of a relationship of trust or confidence owed to the opposite party in the transaction. Absent this fiduciary relationship, the insider is not under a duty to disclose the information to the contemporaneous trader, and thus no actionable fraud occurs. Newman's conduct would not be unlawful under this analysis, because he did not owe a fiduciary duty to the shareholders with whom he traded.

The court that actually decided Newman's case, however, used neither the equal access nor the fiduciary duty theory in reaching its conclusion. Instead, it employed a sort of hybrid model, the "misappropriation theory," to hold Newman guilty of fraud.[7] The misappropriation theory provides that a party who trades on wrongfully-obtained nonpublic information can be held liable solely by virtue of the trader's act of "misappropriating" such information. The theory shifts the actionable fraud from that perpetrated against the contemporaneous trader to that perpetrated against the source of the misappropriated information. Because Courtois "misappropriated" confidential, proprietary information belonging to his employer, his (and Newman's) subsequent trading was held to be in violation of the securities laws.[8]

[4] See infra Part I.B.1 (discussing equal access model).

[5] See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (reasoning that market traders are justified in expecting equal access to material information). See generally Victor Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 355, 360 (1979) (discussing parameters of equal access regime).

[6] See Chiarella v. United States, 445 U.S. 222, 228 (1980) (adopting fiduciary duty rule); see also Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (same). The fiduciary duty model is discussed more extensively infra Part I.B.2.

[7] See *Newman*, 664 F.2d at 16. The case marked the first time a federal circuit court expressly accepted the misappropriation theory.

[8] See id. at 17-18 (holding that defendant's conduct was fraud, and such fraud was in connection with purchase or sale of securities). Newman would also be liable as a "tippee"

After a long gestation in the circuit courts, the misappropriation theory was recently endorsed by the Supreme Court in *United States v. O'Hagan*.[9] At first glance, this doctrinal theory appears an odd compromise between the fiduciary duty and equal access models of insider trading liability.[10] On one hand, like the duty model, liability under the theory is predicated on a breach of fiduciary duty (namely, that which the trader owed to the source of the nonpublic information). On the other hand, like the equal access model, the theory applies to investors who do not stand in a fiduciary relationship with the market participants with whom they trade.

This Note examines the nature of the doctrinal compromise that the misappropriation theory represents. It focuses on the uneasy relationship among the three doctrinal models and argues that, in fact, the misappropriation theory marks a fundamental departure from the Supreme Court's more sensible fiduciary duty analysis, and differs in no meaningful way from an equal access regime of insider trading liability. Since the wrongful activity to which the misappropriation theory attaches liability is so distantly related to the securities trading at issue, any claim that it retains the fiduciary duty framework is simply implausible. Like the equal access model, the theory stretches applicable statutory provisions beyond recognition and cannot be reconciled with the Supreme Court's past interpretation of these provisions.[11]

This Note focuses on the doctrinal support for the misappropriation theory and the strained relationship of those arguments to existing doctrinal frameworks. For that reason, the equally compelling (and often-discussed) issue of the correct regulatory regime as a matter of public policy is saved for another day.[12] Instead, this Note reaches the more limited conclusion that the fiduciary duty model stands on the firmest doctrinal and statutory ground of any theory of insider trading regulation, and that the misappropriation theory's departure from this conceptually sound rubric is undesirable.

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of Courtois under *Dirks*, 463 U.S. at 659-61. See infra note 87-89 and accompanying text (discussing tippee liability).

9 117 S. Ct. 2199 (1997).

10 See Lawrence E. Mitchell, The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back, 52 Alb. L. Rev. 775, 826 (1988) (noting "schizophrenic" nature of misappropriation theory's attempt to bridge doctrinal gap between equal access and fiduciary duty theories).

11 See infra Parts III.A.1 and III.A.2 (discussing doctrinal incompatibility of misappropriation theory with previous Supreme Court interpretations of securities laws).

12 See infra notes 18-28 and accompanying text (outlining policy arguments for and against insider trading regulation).

To sustain this thesis, Part I begins with a discussion of the statutory provisions that govern insider trading regulation. This Part proceeds with an examination of the competing paradigms of insider trading regulation, the equal access and fiduciary duty models, and discusses the courts' treatment of both. Part II describes the evolution of the misappropriation theory in the circuit courts, and finally in the Supreme Court. Part III examines and critiques the doctrinal framework of the misappropriation theory, as compared to the fiduciary duty and equal access models. It also illustrates the curious effect that a rigorous doctrinal application of the misappropriation theory would have on traditional (and important) enforcement tools against insider traders. The Note concludes that in attempting to find a middle ground between the two competing models by endorsing the misappropriation theory, the Supreme Court essentially has abandoned the more convincing doctrinal precepts of the fiduciary duty model of liability.

## I
## THE STATUTORY BASIS AND JUDICIAL IMPLEMENTATION OF INSIDER TRADING REGULATION

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

In 1933 and 1934, in the wake of the stock market crash of 1929 and the Great Depression, Congress enacted its historic securities regulation acts.[13] The legislation had the effect of supplementing, and to a large degree displacing, bodies of existing state law.[14] The Securities

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13 See Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (1994)); Securities Exchange Act of 1934, Pub. L. No. 73-290, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78jj (1994)). See generally Steve Thel, The Original Conception of Section 10(b) of the Securities Exchange Act, 42 Stan. L. Rev. 385 (1990) (discussing congressional intent regarding purpose of Securities Exchange Act of 1934).

14 The effect of the acts in federalizing what had, to that time, been the province of state blue sky laws should not go unnoticed. As discussed further later, see infra notes 176-78 and accompanying text, state law actions for theft, embezzlement and conversion (as well as federal mail and wire fraud) would cover many insider trading cases. See C. Edward Fletcher, Materials on the Law of Insider Trading 45 (1991) ("[M]any of the problems in the securities markets that were until [the 1929 crash] matters of state regulation were thought to be national problems requiring a national solution."). The Supreme Court has expressed some discomfort with the federalizing effect. See, e.g., Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977) (stating unwillingness to "federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden"). But see Carlos J. Cuevas, The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court, 13 J. Corp. L. 793, 795 (1988) (arguing that "common-law fraud action was inadequate for the sophisticated transactions involving insider trading and market manipulation"); Arthur Fleischer, Jr., "Federal Corporation Law": An Assessment, 78 Harv. L.

Exchange Act of 1934[15] contained numerous provisions intended to prevent manipulation of the securities markets through reporting requirements and antifraud regulations applicable to the national exchanges.[16] Included in these provisions were prohibitions on insider trading.[17]

Despite the popular perception of insider trading as an inherently evil activity,[18] the reasons for its prohibition were not (and are not) altogether obvious.[19] Some academics, in fact, have contended that insider trading need not be regulated at all. These commentators have raised three principal arguments. First, they point out that trading by insiders makes the securities markets more efficient by communicating important information to traders.[20] A free and full exchange of information in the financial markets causes stock prices to reflect more accurately the true value of the issuing firm.[21] When insiders trade on the market, the effect of their trading on the stock price "signals" the stock's true value without disclosing information that cannot

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Rev. 1146, 1175 (1965) (noting "ancient and illogical distinctions that at the time haunted state fraud law").

15 15 U.S.C. §§ 78a-78jj (1994).

16 The Securities Act of 1933 likewise contained antifraud provisions. See, e.g., Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (1994) (prohibiting fraud or deceit in connection with sale of securities in interstate commerce).

17 See, e.g., Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (1994); see also infra notes 31-32 and accompanying text (discussing sections 16 and 10(b)).

18 See Robert W. McGee & Walter E. Block, Information, Privilege, Opportunity and Insider Trading, 10 N. Ill. U. L. Rev. 1, 21 (1989) ("To say that insider trading has a bad press and is commonly held in ill repute would be the understatement of the century."). The high profile prosecutions of Michael Milken, Ivan Boesky, and Dennis Levine concentrated press coverage on insider trading, coverage which uniformly criticized the practice. See, e.g., David A. Vise & Steve Coll, Wall Street's Long Year of Turmoil: Market's Massive Insider Trading Scandal Shows No Sign of Fading, Wash. Post, May 10, 1987, at A1 (discussing insider trading scandals).

19 Prior to passage of the Exchange Act in 1934, insider trading by corporate insiders seems to have been regarded as acceptable conduct. See Nasser Arshadi & Thomas H. Eyssell, The Law and Finance of Corporate Insider Trading 43 (1993) (noting then-prevailing view of insider trading as "perquisite granted to corporate insiders").

20 See Stephen Bainbridge, The Insider Trading Prohibition: A Legal and Economic Enigma, 38 U. Fla. L. Rev. 35, 42-45 (1986) (discussing efficiency effects of insider trading activity); Dennis W. Carlton & Daniel R. Fischel, The Regulation of Insider Trading, 35 Stan. L. Rev. 857, 866-72 (1983) (same); Richard J. Morgan, Insider Trading and the Infringement of Property Rights, 48 Ohio St. L. J. 79, 105 (1987) (arguing that market valuation is more accurate when insider trading is allowed). But see Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 629-34 (1984) (arguing that if insider trading is to operate as efficient means of bringing information to securities markets, disclosure of identities of traders and size of their trades must occur).

21 For commentary on the harmful effects of inaccurate securities prices, see Marcel Kahan, Securities Laws and the Social Costs of "Inaccurate" Stock Prices, 41 Duke L. J. 977, 1006-08 (1992).

(for whatever reason) be made public.[22] Second, some suggest that insider trading is an efficient way to compensate corporate management.[23] Third, some scholars have expressed doubt as to whether contemporaneous traders are harmed by insider trading at all, since most "victims" would have bought or sold their securities anyway.[24]

Supporters of Congress's decision to regulate insider trading counter these arguments by pointing out that such activity creates perverse incentives for corporate management,[25] can cause delays in the publicizing of information,[26] and may discourage legitimate market analysis because of the insurmountable advantage insiders would possess.[27] The most commonly advanced argument, however, is one of fairness. Insider trading is unfair, or at least perceived to be unfair,

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22 The market valuation of a security better reflects its "true value" when all relevant information about that security is made known to market traders. The effect that insiders' trading on nonpublic information has on securities prices can, by itself, communicate information about that security to the market. Professors Carlton and Fischel argue that such signaling is beneficial when "an announcement would destroy the value of the information, would be too expensive, not believable, or—owing to the uncertainty of the information—would subject the firm to massive damage liability if it turned out ex post to be incorrect." Carlton & Fischel, supra note 20, at 868.

23 See Henry G. Manne, Insider Trading and the Stock Market 138-41 (1966) (advocating use of insider trading opportunities as effective incentive compensation for management, at minimal cost to investors); Carlton & Fischel, supra note 20, at 869-72 (same); see also David D. Haddock & Jonathan R. Macey, A Coasian Model of Insider Trading, 80 Nw. U. L. Rev. 1449, 1458-66 (1986) (responding to criticisms of use of insider trading opportunities as compensation).

24 See Langevoort, supra note 3, at 41 (questioning existence of damages in insider trading cases); William H. Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5, 65 Colum. L. Rev. 1361, 1381 (1965) (same).

25 Commentators point to two types of inefficient incentives. First, insider trading in options allows insiders to profit from occurrences that *negatively*, as well as positively, affect the firm's value and, therefore, its stock price. See, e.g., Saul Levmore, Securities and Secrets: Insider Trading and the Law of Contracts, 68 Va. L. Rev. 117, 149 (1982); Morris Mendelson, Book Review, The Economics of Insider Trading Reconsidered, 117 U. Pa. L. Rev. 470, 489-90 (1969) (reviewing Henry G. Manne, Insider Trading and the Stock Market (1966)). Second, insider trading creates incentives for management to undertake risky projects, because risky projects more often result in wide swings (up or down) in the price of the firm's stock. Wide swings offer the greatest opportunities for trading profits for insiders. See, e.g., Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 S. Ct. Rev. 309, 332; Gilson & Kraakman, supra note 20, at 632 n.221; Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L. J. 1083, 1095 (1985).

26 See Robert Charles Clark, Corporate Law § 8.2.3, at 268 (1986) (discussing publicizing delays as result of insider trading activity); Robert J. Haft, The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation, 80 Mich. L. Rev. 1051, 1053-60 (1982) (same).

27 See Jonn R. Beeson, Comment, Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory, 144 U. Pa. L. Rev. 1077, 1095 (1996) (discussing "overwhelming informational advantage" of insiders).

because the insider's trading advantage comes not from personal initiative but solely from her position as an insider.[28] The Supreme Court has expressed concern about the chilling effect this perceived unfairness might have on the public's willingness to invest in securities.[29] To be sure, one of Congress's primary purposes in enacting the federal securities laws was to restore investor confidence in the markets in the wake of the crash of 1929.[30]

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[28] See Roy A. Schotland, Unsafe at Any Price: A Reply to Manne, *Insider Trading and the Stock Market*, 53 Va. L. Rev. 1425, 1439 (1967) (arguing that even if insider trading were to result in economic gains, it should be prohibited on fairness grounds); see also Robert J. Kuker, Insider Trading Liability of Tippees and Quasi-Insiders: Crime Shouldn't Pay, 22 J. Marshall L. Rev. 295, 321-22, 327-30 (1988) (discussing fairness rationales). But see Fisch, supra note 3, at 221 n.189 ("It is unclear why disparate access to information and the exploitation of that access present a unique problem in the securities industry. Business transactions are routinely predicated on the fact that one party to the transaction has superior information of which it intends to take advantage."); McGee & Block, supra note 18, at 24:

> [I]f we are to punish inside stock market traders, what about others who engage in commercial activities? Does this apply to the housewife who hears from her hairdresser, who was told by her sister, the stock clerk at a department store, that a bargain sale was soon to be put into effect?

The information that savvy investors bring to the market is widely considered to be socially useful, and few supporters of insider trading regulation have argued that its reach should go so far as to prevent market analysts from trading on their lawfully obtained research. See, e.g., Brudney, supra note 5, at 355 (arguing that equal access "concept" does not "extend so far as to require actual equality or sharing of information") (footnote omitted). But see Seligman, supra note 25, at 1137-40 (advocating strict parity-of-information rule).

[29] In holding that investors are entitled to rely on the integrity of the securities markets, the Supreme Court in Basic Inc. v. Levinson, 485 U.S. 224 (1988), questioned, "'Who would knowingly roll the dice in a crooked crap game?'" Id. at 247 (quoting Schlanger v. Four-Phase Systems Inc., 555 F. Supp. 535, 538 (S.D.N.Y. 1982)). Whatever the degree of perceived unfairness in the marketplace, it does not seem to have damaged investors' confidence significantly enough to discourage them from investing altogether. See Charles C. Cox & Kevin S. Fogarty, Bases of Insider Trading Law, 49 Ohio St. L.J. 353, 354 (1988) (claiming that despite publicity of high profile insider trading cases, few, if any, investors have left securities markets because they believe them to be unfair).

[30] See H.R. Rep. No. 73-1383, at 5 (1934) ("If investor confidence is to come back to the benefit of exchanges and corporations alike, the law must advance."). Congress also made similar remarks on enacting the Insider Trading and Securities Fraud Enforcement Act of 1988, H.R. Rep. No. 100-910 (1988), reprinted in 1988 U.S.C.C.A.N. 6043. "[T]he Committee views these steps as an essential ingredient in a program to restore the confidence of the public in the fairness and integrity of our securities markets. . . . [S]mall investor[s] will be . . . reluctant to invest in the market if [they] feel[ ] it is rigged against [them]." Id. at 7-8 (1988), reprinted in 1988 U.S.C.C.A.N. at 6044-45; see also infra note 108 (discussing Insider Trading and Securities Fraud Enforcement Act). Professor Brudney, as well as Professors Gilson and Kraakman, explain that investors' uncertainty as to the complete accuracy of the information available to them may cause them to demand higher prices for capital. See Brudney, supra note 5, at 335; Gilson & Kraakman, supra note 20, at 595-96.

Congress provided the tool for regulating insider trading activity in the broad, "catchall" antifraud provision of section 10(b),[31] which made it unlawful for any person

> [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[32]

The SEC, pursuant to Congress's grant of rulemaking authority,[33] promulgated Rule 10b-5[34] in 1942,[35] which makes it unlawful

> (a) To employ any device, scheme, or artifice to defraud,
> . . . or

31 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994). Congress addressed insider trading directly in section 16 of the Exchange Act. See Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p (1994). Section 16 requires insiders (i.e., directors and officers) to report to the SEC any of their own purchases or sales in their company's stock, and makes short swing profits recoverable by the firm. See id. The legislative history of section 16 makes clear that it was the primary weapon Congress intended the SEC to use in combating insider trading. See H.R. Rep. No. 73-1383, at 13 (1934) (noting congressional intent to provide "prompt publicity" of inside information to prevent abuse of such information); see also Fletcher, supra note 14, at 99 (noting that section 16 was original statutory provision designed to deal with insider trading). Section 16 was of limited utility to the SEC, however, because its reach was so limited. See id. (noting that section 16 "was (and is) useless in most cases because it is so underinclusive"); see also H.R. Rep. No. 73-1383, at 13 (1934) (illustrating awareness "that [section 16's] requirements are not air-tight and that the unscrupulous insider may still, within the law, use inside information for his own advantage").

32 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (1994). Two particular phrases in this language are especially important for further discussion: the requirement of a "deceptive device," and the requirement that said device be employed "in connection with the purchase or sale of any security." Id. The "deceptive device" analysis turns on the common law understanding of the term "deceit," which refers specifically to a material misrepresentation or material failure to disclose. See infra note 80 and accompanying text (discussing Supreme Court's interpretation of deceit); see also infra Part III.A.1 (discussing misappropriation theory's treatment of deceit requirement). The "in connection with" analysis involves an examination of the jurisdictional nexus of the deceit to the securities trading at issue. See infra Part III.A.2 (discussing misappropriation theory's treatment of nexus requirement). A private plaintiff or, in an enforcement action, federal prosecutor must be able to prove both of these statutory requirements to have a colorable claim.

33 See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (noting that SEC is not authorized, in its rulemaking power, to exceed Congress's grant of authority in applicable statute).

34 17 C.F.R. § 240.10b-5 (1996).

35 See generally Joseph A. Grundfest, Disimplying Private Rights of Action Under the Federal Securities Laws: The Commission's Authority, 107 Harv. L. Rev. 963 (1994), in which the former SEC Commissioner references the eight years between the passage of the Exchange Act in 1934 and the adoption of Rule 10b-5 in 1942 as evidence that the language of the statute did not necessarily demand a proscription of Rule 10b-5's scope. "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. at 981 n.74.

> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[36]

The legislative history behind the enactment of section 10(b)[37] and the promulgation of Rule 10b-5[38] is limited to anecdotal information and nonspecific congressional remarks. The only legislative purpose that emerges with any clarity is a general intent to combat fraud, including insider trading, in the securities markets.[39] Though neither defines in-

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36 17 C.F.R. § 240.10b-5 (1996).

37 See Harvey L. Pitt & Karen L. Shapiro, The Insider Trading Proscriptions Act of 1987: A Legislative Initiative for a Sorely Needed Clarification of the Law Against Insider Trading, 39 Ala. L. Rev. 415, 416 (1988) (discussing legislative history of section 10(b)). In his dissenting opinion in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), Justice Blackmun discussed the legislative history of the Exchange Act. He quoted Senator Fletcher, Chairman of the Senate Committee on Banking and Currency, in introducing the bill that became the Exchange Act: "Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them . . . ." Id. at 765 (Blackmun, J., dissenting) (quoting 78 Cong. Rec. 2271 (1934) (statement of Sen. Fletcher)). Fletcher directly addressed the problem of insider trading: "[B]esides forbidding fraudulent practices and unwholesome manipulations by professional market operators, the bill seeks to deprive corporate directors, corporate officers, and other corporate insiders of the opportunity to play the stocks of their companies against the interests of the stockholders of their companies." Id.

38 In *Blue Chip Stamps,* Justice Blackmun also quoted a well known story involving the promulgation of Rule 10b-5, as told by the rule's author, former SEC staff attorney Milton Freeman:

> It was one day in the year 1943, 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 at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. 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 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.
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> 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.

Id. at 767 (Blackmun, J., dissenting) (quoting Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 922 (1967)).

39 The courts have frequently construed section 10(b) and Rule 10b-5, in the absence of legislative history, to be concerned primarily with fraud. See, e.g., Chiarella v. United States, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); see also *Blue Chip Stamps,* 421 U.S. at 766 (Blackmun, J., dissenting) (citing 1942 SEC release announcing that "'[t]he new rule closes

sider trading explicitly, these rules, as interpreted by the SEC and the federal courts, form the bedrock of all insider trading regulation.[40]

In its watershed opinion *In re Cady, Roberts & Co.*,[41] the SEC first applied section 10(b) and Rule 10b-5 to an insider trading case. Chairman Cary concluded that the defendants, who had sold 7,000 shares of the Curtiss-Wright Corporation after learning that it was about to cut its dividend, had breached a duty to disclose the nonpublic information or to refrain from trading altogether.[42] The "disclose or refrain" rule would become a touchstone in the doctrinal debate that *Cady, Roberts* precipitated.

As discussed above, scholars have not agreed that insider trading should be regulated at all.[43] Once the SEC began to use section 10(b) and Rule 10b-5 to prosecute insider traders, however, the key question became more pragmatic: When should a trader's informational advantage in the marketplace trigger the antifraud provisions of the securities laws? In their long struggle to answer this question, courts and academics have developed two basic doctrinal models on which to base regulation of insider trading, the "equal access" theory and the "fiduciary duty" model.

### B. *The Doctrinal Debate*

#### 1. *The Equal Access Theory*

The equal access theory rests on the normative assumption that, in the securities marketplace, all investors should have relatively equal access to material information.[44] Professor Victor Brudney, the best-known academic supporter of the theory, has put it this way:

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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'") (quoting 1934 Securities Exchange Act Release No. 3230, 100 Fed. Reg. 3804-05 (May 21, 1942)).

[40] The SEC also enacted, in 1980, Rule 14e-3, 17 C.F.R. § 240.14e-3 (1996), which flatly prohibits insider trading in connection with tender offers. The defendants in United States v. O'Hagan, 117 S. Ct. 2199 (1997), discussed infra Part II.B, challenged the rule as exceeding the SEC's rulemaking authority. See id. at 2214. The Court rejected the argument and upheld the rule. See id. at 2219. A thorough discussion of Rule 14e-3 is beyond the scope of this Note. For further discussion, see generally Janell M. Kurtz & Bradley J. Sleeper, Fraud Liability for Insider Trading: SEC Rule 14e-3 in Limbo, 29 Am. Bus. L.J. 691 (1992).

[41] 40 S.E.C. 907 (1961).

[42] See id. at 912.

[43] See supra notes 19-24 and accompanying text (discussing arguments in favor of deregulation of insider trading).

[44] See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (discussing fairness rationales for equal access rule).

> [The equal access model] would presumably deny an informational advantage to those who seek to use otherwise nonpublic information which they are precluded by legal restrictions from disclosing to public investors. . . . [T]he logic of the disclose-or-refrain rule precludes exploitation of an informational advantage that the public is unable lawfully to overcome or offset.[45]

It is important to note that the theory's reach does not extend so far as to require actual equality of information between parties in a securities transaction; rather, only information that is legally unobtainable to the contemporaneous trader triggers the disclose or refrain rule.[46]

Critics of the model claim that such a regime would stifle the efforts of financial analysts to bring information to the markets.[47] Professor Brudney concedes that a rule demanding an absolute parity of information would destroy the incentives of market professionals to obtain valuable information (which, importantly, makes the price of market securities a more accurate measurement of true value).[48] The service analysts perform may not occur if they are not able to recover the rewards of their investments in research—rewards that the equal access theory reallocates to parties with whom the analysts trade.

Brudney and others answer this criticism by arguing that the equal access model only prohibits trading based on information that is

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45 Brudney, supra note 5, at 355, 360; see also Chiarella v. United States, 445 U.S. 222, 251-52 (1980) (Blackmun, J., dissenting) (citing and advocating Brudney's analysis). Some commentators have referred to this model of liability as a "parity-of-information" rule, rather than "equal access." See, e.g., Kimberly D. Krawiec, Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing *United States v. O'Hagan*, 33 Tulsa L.J. 163, 169 (1997). This Note distinguishes the equal access rule from the parity-of-information rule, and refers to the latter only in its more commonly understood meaning as an actual equality of information between market traders.

46 See Brudney, supra note 5, at 355 (rejecting parity-of-information rule); see also Douglas M. Branson, Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading, 30 Emory L.J. 263, 271 (1981) (same). But see Seligman, supra note 25, at 1087 (advocating strict parity-of-information rule). One commentator has tersely posed the relevant question: "[W]hen will we allow individuals to play the game of securities trading when they possess information that other players do not have and cannot get, no matter how much effort they put forth? . . . [T]here are only three possible answers to this question—always, never, and sometimes . . . ." Krawiec, supra note 45, at 165. A strict parity-of-information rule would seem to answer the question "never," while both the equal access and fiduciary duty models would answer "sometimes."

47 See, e.g., Cox & Fogarty, supra note 29, at 355 ("A prohibition that discourages use of information other than that already discovered necessarily discourages the discovery of new information and inhibits the use of information whose public or nonpublic status is uncertain.").

48 See Brudney, supra note 5, at 360 ("The values of efficiency in pricing and resource allocation served by encouraging pursuit of information about the worth of securities are diluted, if not destroyed, by a [parity-of-information rule] . . . ."); see also supra note 20 (discussing effect of full information on accuracy of market valuation of securities).

not *legally* obtainable by non-insiders.[49] Legitimately obtained information is not prohibited. Nevertheless, the line between legitimately obtained and illegitimately obtained information, particularly for the well connected Wall Street insider with access to a wealth of market information, would not be an easy one to draw.[50] The chilling effect an equal access rule would have on the risk averse financial analyst is undeniable.

Equal access advocates further assert that their approach is supported by notions of fundamental fairness.[51] It is surely unfair, the argument goes, for investors to be penalized in the marketplace for not knowing that which they had no legally permissible means of discovering.[52] Professor Brudney laments the unfairness of the insider having a "lawful monopoly on access to the information involved . . . which cannot be competed away . . . ."[53] As suggested in the previous section, however, it is not obvious why informational asymmetry should be regarded as unfair.[54] As in other contractual contexts, it is apparent to most participants in the securities markets that professional analysts possess access to information, through both public and nonpublic channels, that ordinary investors do not. If the service of bringing such information to the market is regarded as socially useful (to amateur, as well as professional, investors), one could question the fairness in denying analysts their "finder's fee."

The brief life of the equal access theory in the courts began with the Second Circuit's opinion in *SEC v. Texas Gulf Sulphur Co.*[55] In that case, the officers of Texas Gulf Sulphur purchased blocks of the company's stock before announcing a valuable strike of zinc, copper, and silver in company-owned property.[56] The court held the officers

[49] See Brudney, supra note 5, at 360-61 (arguing that efficiency is not impeded if information obtained via "unerodable information advantage" is prohibited as basis for trading); see also Scott S. Kunkel, Insider Trading: A New Equal Access Approach, 15 J. Contemp. L. 51, 68 (1989) (pointing out that reach of equal access rule extends only to illegally obtained information).

[50] See Fisch, supra note 3, at 223 (questioning analysts' ability to determine whether informational advantage is permissible); see also John F. Barry III, The Economics of Outside Information and Rule 10b-5, 129 U. Pa. L. Rev. 1307, 1309 n.11 (1981) ("The same information can . . . be either inside or outside information.").

[51] See supra notes 28-30 and accompanying text (discussing fairness rationales for insider trading regulation). But see McGee & Block, supra note 18, at 25 ("[I]t is by no means unfair that stock market information is not equated over all participants.").

[52] See generally Kim Lane Scheppele, "It's Just Not Right": The Ethics of Insider Trading, Law & Contemp. Probs., Summer 1993, at 123 (discussing unfairness of insider trading in securities markets).

[53] Brudney, supra note 5, at 346.

[54] See supra notes 19-24 and accompanying text; see also supra note 28.

[55] 401 F.2d 833 (2d Cir. 1968) (en banc).

[56] See id. at 846-47.

guilty of violations of section 10(b) and Rule 10b-5,[57] reasoning that Rule 10b-5 "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[58] The court's normative "fairness" analysis exposed to liability anyone in possession of material nonpublic information.[59] A trader possessing such information was required to either disclose the information to the trading public or abstain from trading in the securities of the concerned companies altogether.[60]

### 2. *The Fiduciary Duty Model*

The fiduciary duty model holds the insider liable when her trading activity constitutes a breach of "a relationship of trust and confidence between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their posi-

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57 See id. at 863.

58 Id. at 848. In In re Cady, Roberts, 40 S.E.C. 907 (1961), the Commission pointed out "the inherent unfairness involved where a party takes advantage of [inside] information knowing it is unavailable to those with whom he is dealing." Id. at 912. This effect oriented approach is conceptually similar to the equal access reasoning adopted by the Second Circuit: Because the effect of the trading is inherently unfair, it is prohibited.

59 The court rejected the argument that the insider must have owed a fiduciary duty to disclose the nonpublic information to the contemporaneous trader for such nondisclosure to be actionable. See *Texas Gulf Sulphur*, 401 F.2d at 848. In *Cady, Roberts*, the Commission had stated that the "disclose or refrain" duty rested in part on "the existence of a relationship giving access . . . to information intended to be available only for a corporate purpose and not for the personal benefit of anyone." *Cady, Roberts*, 40 S.E.C. at 912. The Second Circuit reasoned that a rule requiring the existence of such a relationship would be too restrictive a reading of Rule 10b-5. See *Texas Gulf Sulphur*, 401 F.2d at 848.

60 Several other circuits, for a time, supported such a rationale. See, e.g., Freeman v. Decio, 584 F.2d 186, 189 (7th Cir. 1978) (adopting equal access rule); Fridrich v. Bradford, 542 F.2d 307, 318 (6th Cir. 1976) (same); Johnson v. Wiggs, 443 F.2d 803, 806 (5th Cir. 1971) (same). *Texas Gulf Sulphur* was a criminal enforcement action brought by the SEC. The case left open the question of whether a private right of action for damages would be available to contemporaneous traders. In a case decided six years later, the Second Circuit answered that question in the affirmative. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974) (holding that private rights of action do lie for contemporaneous traders). The court rejected as unworkable the defendant's argument that privity was required, and therefore only the specific shareholders with whom the defendant traded had standing to sue. See id.; see also Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 173 (2d Cir. 1980) (ruling damages not limited to out-of-pocket loss of named plaintiff, but should constitute complete disgorgement of wrongfully obtained profits). One year later, the Supreme Court limited 10b-5 private action standing to plaintiffs who actually purchased or sold securities. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 747 (1975). The Court rejected the argument that prospective purchasers who declined to buy, and prospective sellers who declined to sell (as a result of the effect the insider trading had on the market for the security), should have standing to sue. See id.

tion in that corporation."[61] At common law, parties to a transaction who possess an informational advantage are not required to disclose their superior knowledge. The parties are thereby given an incentive to seek out full information, a socially useful activity. The important exception to this rule, however, arises when the transactional parties are fiduciaries, "since the fiduciary's failure to disclose material facts to a person who is entitled to rely on him is a tacit representation of the nonexistence of those facts."[62] This relationship, and only this relationship, imposes on the corporate insider a duty either to disclose the information or to abstain from trading altogether.[63] Because, as a common law rule, nondisclosure is fraudulent only when the trader is under a duty to speak, only nondisclosure by a fiduciary is actionable under this analysis.

The Supreme Court first established the fiduciary duty rule in *Chiarella v. United States.*[64] The defendant, Vincent Chiarella, was an employee of a prominent financial printing firm in New York City called Pandick Press.[65] By examining the financial documents being printed in the shop, Chiarella was able to identify companies that were targeted for acquisitions.[66] He purchased stock in the target

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[61] Chiarella v. United States, 445 U.S. 222, 227-28 (1980). Directors and officers have a fiduciary duty to shareholders of the firm to promote the firm's interests in good faith. See 1 William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors 1-7, at 15 (5th ed. 1993); see also R. René Pengra, Insider Trading, Debt Securities, and Rule 10b-5: Evaluating the Fiduciary Relationship, 67 N.Y.U. L. Rev. 1354, 1370 (1992) ("[T]he relationship between shareholders, corporations, and their management has been recognized as a paradigm case where special duties must be implied . . . ." (footnote omitted)). Therefore, the insider breaches that relationship of trust when she trades on the basis of inside information because she will necessarily deal with one of the corporation's shareholders. This is so when the insider sells, as well as buys, the firm's securities (even though the buyer may not be a shareholder until the sale is consummated). See Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951) (L. Hand, J.):

> [T]he 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.

Cf. Strong v. Repide, 213 U.S. 419, 431-33 (1909) (creating "special facts" doctrine, in which controlling shareholder is obliged to reveal special facts to minority shareholder regarding trades in firm's securities).

[62] Barbara Bader Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 116 (1984); see also Restatement (Second) of Torts § 551(2)(a) (1976) (stating that duty to speak arises out of "fiduciary or other similar relation of trust and confidence"); 1 Fowler V. Harper & Fleming James, Jr., The Law of Torts § 7.14, at 586 (1956) (discussing nondisclosure of material information by fiduciaries).

[63] See Aldave, supra note 62, at 116 (noting general rule that affirmative disclosure is not required among parties in business transactions).

[64] 445 U.S. 222 (1980).

[65] See id. at 224.

[66] See id.

companies before the acquisitions were announced and realized profits when the market price of the shares rose.[67] He was convicted on seventeen counts of violating section 10(b) and Rule 10b-5.[68] The Second Circuit, again adopting its *Texas Gulf Sulphur* equal access rationale, affirmed the convictions.[69] The court reasoned that "[t]he draftsmen of our nation's securities laws, rejecting the philosophy of *caveat emptor*, created a system providing equal access to the information necessary for reasoned and intelligent investment decisions."[70]

The Supreme Court reversed.[71] In an opinion by Justice Powell, the Court established the requirement of a breach of fiduciary duty as a predicate to insider trading liability.[72] Noting that section 10(b) is foremost an antifraud provision, the Court reasoned that "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."[73] The majority concluded that a duty to disclose is created only when "'the other [party] is entitled to know [the information] because of a fiduciary or other similar relation of trust and confidence between them.'"[74] Because Chiarella, an employee of Pandick Press and not the company in which the contemporaneous traders owned stock, did not stand in a fiduciary relationship with those shareholders, the Court reversed the convictions.[75] This ruling was to form the foundation of the duty model of liability.[76]

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67 See id.

68 See id. at 225.

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

70 Id. at 1362. The court rejected Chiarella's argument that he was under no duty to disclose the information because he was not in a fiduciary relationship with the company that issued the securities (and thus the shareholders with whom he traded). See id. at 1365 ("In enacting the securities laws, Congress did not limit itself to protecting shareholders from the peculations of their officers and directors. A major purpose of the antifraud provisions was to 'protect the integrity of the marketplace in which securities are traded.'" (quoting United States v. Brown, 555 F.2d 336, 339 (2d Cir. 1977))).

71 See *Chiarella*, 445 U.S. at 225.

72 See id. at 228 (detailing elements of fiduciary duty requirement); see also Langevoort, supra note 3, at 48 (noting that *Chiarella* majority "made it clear that recognizing a fiduciary duty was paramount in resolving the case").

73 *Chiarella*, 445 U.S. at 228.

74 Id. (quoting Restatement (Second) of Torts § 551(2)(a) (1976)); see also Peter Tiersma, The Language of Silence, 48 Rutgers L. Rev. 1, 51 (1995) (discussing common law duties of disclosure).

75 See *Chiarella*, 445 U.S. at 232-33.

76 Though the Court did not state, in express terms, the particular fiduciary relationship that must be breached, many courts have concluded that the duty must be owed to the party with whom the insider trades. See, e.g., United States v. Bryan, 58 F.3d 933, 946, 950 (4th Cir. 1995) (interpreting "in connection with" language of section 10(b) to require that victim of fraud be purchaser or seller of securities).

The Court returned to the definitions for "manipulation" and "deception," the conduct prohibited by 10(b),[77] that it had provided three years earlier in *Santa Fe Industries v. Green*.[78] Because manipulation had been defined as a term of art involving practices clearly not at issue in the case,[79] the *Chiarella* majority turned to deception, defined previously as "a material misrepresentation or material failure to disclose."[80] The government, unable to allege misrepresentation, rested its argument on Chiarella's nondisclosure to the contemporaneous traders. The Court's rejection of this argument was founded on the common law rule that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."[81] Silence alone was not a basis for liability in the duty model regime *Chiarella* established.

The *Chiarella* majority expressly rejected the equal access theory advocated by Justice Blackmun in his dissent.[82] The majority argued that adoption of such a rule was tantamount to

> recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the

[77] See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).

[78] 430 U.S. 462 (1977). In *Santa Fe Industries,* the Court held in no uncertain terms that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." Id. at 473. Though the conduct of the defendant in *Santa Fe Industries*—a majority shareholder who executed a freezeout merger to the detriment of minority shareholders—was certainly unfair, the Court held that it was not manipulative. See id. at 476. Nor was the act one of deception, which the Court defined as "a material misrepresentation or material failure to disclose." Id. at 474. Therefore, the defendant's conduct did not fall within the reach of section 10(b). See id. at 476-77. Significantly, the Court concluded that an interpretation of actionable fraud under 10(b) that included any and all breaches of fiduciary duty in connection with a securities transaction would be too broad. Congress did not intend the judiciary to extend 10(b)'s reach to "'cover the corporate universe.'" Id. at 480 (quoting William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 700 (1974)). The author of the cited article, Professor Cary, was the former Chairman of the SEC and author of the *Cady, Roberts* opinion.

[79] The Court considered the word "manipulation" to be "'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. at 476 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).

[80] Id. at 474.

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

[82] Justice Blackmun eschewed the fiduciary relationship requirement, reasoning 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); see also id. at 246 (Blackmun, J., dissenting) (opining that "petitioner's brand of manipulative trading . . . lies close to the heart of what the securities laws are intended to prohibit").

> established doctrine that duty arises from a specific relationship between two parties... should not be undertaken absent some explicit evidence of congressional intent....
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> ....
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> ... [N]either the Congress nor the [Securities and Exchange] Commission ever has adopted a parity-of-information rule.[83]

The assumption lying at the heart of the equal access theory, that all market participants are entitled to equal access to information, was thereby deemed to be one that only Congress could make.

In *Dirks v. SEC*,[84] the Court dealt with the liability of a nonfiduciary (a "tippee") who received nonpublic information about a company from a former officer of that company (a "tipper").[85] Justice Powell's opinion began where *Chiarella* left off, with a strong statement of the fiduciary relationship requirement.[86] The Court stated that the tippee's mere receipt of information did not create such a relationship between the shareholders of the company and him,[87] and thus did not give rise to a duty to disclose.[88] Moreover, the Court

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[83] *Chiarella*, 445 U.S. at 233.

[84] 463 U.S. 646 (1983).

[85] In *Dirks*, the defendant, a securities analyst, received a call from a former officer of Equity Funding of America. The employee urged Dirks to investigate and publicize widespread instances of fraud in the company, including the vast overstatement of assets. See id. at 649. Dirks decided to undertake the investigation by interviewing company insiders, who in turn corroborated the employee's allegations. While he investigated the matter, Dirks discussed his suspicions freely with his clients. See id. As a result, several clients, some large institutional investors with significant stakes in Equity Funding securities, liquidated their holdings (in aggregate, over sixteen million dollars worth of securities). See id. When the fraudulent activity was finally exposed in the media, Equity Funding securities plunged in value. See id. at 650. In its prosecution, the SEC argued that as a tippee of a true corporate insider, Dirks had effectively inherited that insider's fiduciary duty to disclose or refrain. See id. at 655-56.

[86] See id. at 654-55; see also Langevoort, supra note 3, at 56 (noting that *Dirks* eliminated "any remaining doubt that the existence of a fiduciary duty to disclose ... is a *sine qua non* of abstain or disclose liability").

[87] The Court did, however, recognize a class of temporary insiders, such as underwriters, accountants, attorneys, or consultants, who could be subject to fiduciary duties and the attendant duty to disclose or abstain. See *Dirks*, 463 U.S. at 655 n.14. The Court emphasized, however, that "[t]he basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." Id. The Court's definition of temporary insiders might have included Vincent Chiarella, demanding a different result in that case. See Troy Cichos, The Misappropriation Theory of Insider Trading: Its Past, Present, and Future, 18 Seattle U. L. Rev. 389, 397 n.63 (1995) (applying *Dirks*' temporary insider doctrine to facts of *Chiarella*).

[88] Rather, a tippee assumes a duty to disclose or abstain "only when the [tipper] has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach." *Dirks*, 463 U.S. at 660. Regarding the potential liability of the former Equity Funding officer, Dirks' "tip-

found that "the SEC's theory of tippee liability . . . appears rooted in the idea that the antifraud provisions require equal information among all traders," and was objectionable on that ground as well.[89]

The *Chiarella* and *Dirks* Courts established the viability of the fiduciary duty model, and the unsustainability of the equal access theory, in 10(b) actions for insider trading. The fiduciary duty and equal access theories represent the polar extremes of regulatory philosophies. While the former's grasp is selective and rests on a firm common law foundation, the latter's reach is wide and rooted in more subjective notions of fairness. Insider trading jurisprudence can be characterized as a struggle to reconcile these two ultimately incompatible theories. Indeed, the misappropriation theory, discussed in the following Part, seems little more than an earnest attempt to find a middle ground between them—an effort that, as a matter of doctrine, proves unsatisfactory.

## II
## The Evolution of the Misappropriation Theory

This Part traces the misappropriation theory's journey through the federal courts to its eventual acceptance by the Supreme Court in *United States v. O'Hagan*.[90] It begins with the theory's earliest endorsement, by Chief Justice Burger in his *Chiarella* dissent,[91] and proceeds to discuss the subsequent circuit split over its doctrinal validity. The Part concludes by examining the *O'Hagan* case itself.

### A. *Early Judicial Development*

In its brief to the Supreme Court in *Chiarella*, the United States argued that the defendant breached a duty to Pandick Press and their

per," the Court held that a breach of fiduciary duty occurs when the tipper "personally will benefit, directly or indirectly, from his disclosure." Id. at 662.

89 Id. at 657. The Court stated: "We reaffirm today that '[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market.'" Id. at 657-58 (quoting Chiarella v. United States, 445 U.S. 222, 231 n.14 (1980)). Adopting traditional arguments against the equal access model, the majority pointed out that "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market." Id. at 658. Chief Justice Burger expressed similar sentiments in his *Chiarella* dissent, where he noted that a rule that parties are not obligated to disclose information in arm's length transactions "permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting." *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

90 117 S. Ct. 2199 (1997).

91 See *Chiarella,* 445 U.S. at 245 (Burger, C.J., dissenting).

printing clients when he traded on information he obtained by virtue of his position as a Pandick employee.[92] The government argued that the two frauds perpetrated, one against the clients and one against Pandick itself, constituted violations of section 10(b). While the majority held that Chiarella was not in a fiduciary relationship with the target company in whose securities he traded (and therefore did not defraud its shareholders), it did not reject the argument that the fraud against Pandick might constitute a 10(b) violation.[93] The Court did not decide the issue, however, because it was not presented to the jury.[94]

Chief Justice Burger, however, was not ready to drop the argument. His dissent in *Chiarella* would form the foundation of the misappropriation theory as a vehicle for insider trading regulation.[95] Burger reasoned that because the defendant "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence," and then "exploited his ill-gotten informational advantage by purchasing securities in the market," his conduct should be held to violate the antifraud provisions.[96] Anytime an investor obtains information "not by superior experience, foresight, or industry, but by some unlawful means," that investor is under an absolute duty (owed directly to the contemporaneous traders) to disclose or abstain from trading.[97]

Chief Justice Burger's, and to some degree the entire Court's, willingness to entertain the misappropriation theory precipitated a strong reaction in the circuit courts. The Second Circuit took the lead

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92 See id. at 235 & n.20, 236 (outlining Government's misappropriation argument). For discussion on the argument's derivation, see Langevoort, supra note 3, at 161 (noting that prosecutors probably "derived this argument from the law of mail and wire fraud—the principal federal weapons against white collar crime—which has a long history of finding fraud in breaches of fiduciary duty by employees involving the misuse of proprietary information").

93 See *Chiarella*, 445 U.S. at 237 n.21 (discussing Chief Justice Burger's argument for finding of securities fraud in defendant's breach of duty to employer).

94 See id. at 236 ("Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, we will not speculate upon whether such a duty exists . . . ."). Justice Brennan, in an opinion concurring in the judgment, agreed that the misappropriation theory was not an issue before the Court. See id. at 239 (Brennan, J., concurring). He did, however, approve of the theory itself for many of the reasons advanced by Chief Justice Burger in his dissent. See id. (noting that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities").

95 See generally Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 830 (3d ed. 1995) (discussing origin of misappropriation theory in Burger dissent).

96 *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting).

97 Id. at 240.

a year later in *United States v. Newman*,[98] a case that accepted for the first time the misappropriation theory of liability. The court emphasized the effect-oriented analysis that had been so important in its earlier equal access opinions:[99] The defendants' acts of misappropriating the merger information from the investment banks was fraud "as surely as if they took their money."[100]

The defendants argued that the misappropriation was not "in connection with the purchase or sale of any security,"[101] and thus was not prohibited by section 10(b). The court disagreed. The "in connection with" requirement was satisfied because the sole purpose of Newman's wrongdoing was to take advantage of the misappropriated information on the securities markets.[102] Perhaps most important, the court ruled that the defrauded party need not have been a purchaser or seller of securities for the act to constitute fraud under the misappropriation theory.[103] While in traditional insider trading cases the

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[98] 664 F.2d 12 (2d Cir. 1981); see also supra text accompanying notes 1-3.

[99] See, e.g., United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978) (adopting equal access model of liability), rev'd, 445 U.S. 222 (1980); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc) (same); see also supra Part I.B.1 (discussing development of equal access theory).

[100] *Newman*, 664 F.2d at 17. The court found that the investment banks had suffered real damage as a result of Newman's trading, since their reputations as "safe repositories of client confidences" had been sullied. Id. It is not clear that the theft or misappropriation of the bank's property rights in the information constituted actual fraud. For a vigorous argument that it did not, 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, 188-89 (1995); see also Langevoort, supra note 3, at 165 ("It is by no means obvious that trading on the basis of information entrusted to one, in violation of a duty not to profit personally from it, is anything but a breach of fiduciary duty."). Professor Fischel points out that because ideas can be created by different people independently, it is often difficult to determine the "ownership" of such ideas. See Daniel R. Fischel, Payback: The Conspiracy to Destroy Michael Milken and His Financial Revolution 63 (1995). "[T]heft of information or ideas has never been viewed as a violation of the criminal laws except in the most extreme cases such as espionage.... [T]he injury to the victim is too indirect and the risk of punishing those who legitimately develop ideas on their own too great." Id.

[101] Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).

[102] See *Newman*, 664 F.2d at 18. In Superintendent of Ins. of New York v. Bankers Life & Casualty Co., 404 U.S. 6 (1971), the Supreme Court defined the "in connection with" requirement as encompassing any act "touching" the sale of a security. Id. at 12-13. See also Elizabeth M. DeCristofaro, Comment, Trading on Confidential Information—*Chiarella* Takes an Encore: *United States v. Newman*, 56 St. John's L. Rev. 727, 735-37 (1982) (discussing *Newman* court's interpretation of "in connection with" language).

[103] See *Newman*, 664 F.2d at 17. The purchaser or seller requirement, the court reasoned, concerned only the standing of a private plaintiff to sue. See id. This would prove an important sticking point in the Second Circuit's later decision in Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), discussed infra note 108. See also Chiarella v. United States, 445 U.S. 222, 238 (1980) (Stevens, J., concurring) (noting that source of misappropriated information would probably not have standing to sue in private civil action because source would not have been purchaser or seller of securities).

defrauded party was invariably the contemporaneous trader (to whom the duty to disclose the inside information was owed), in this new world of liability no such *Chiarella* duty is established or, for that matter, necessary.[104]

The Second Circuit's loose interpretation of the statutory language and Supreme Court precedent would be an ongoing characteristic of the development of the misappropriation theory in the courts. By attaching liability to the trader's breach of fiduciary duty to the informational source, despite its attenuated relationship to the trading at issue, the court could claim that its broader regulatory scheme still fit in the duty model rubric.[105] The Ninth[106] and Seventh[107] Circuits would eventually follow suit, essentially adopting the *Newman* analysis.[108]

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[104] The Second Circuit affirmed the principles of *Newman* in factually similar cases decided three, and then twelve, years later. See SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) ("In light of this court's holding in [*Newman*], we hold that [misappropriation does] lie within the proscriptive purview of the antifraud provisions of the securities laws."); United States v. Teicher, 987 F.2d 112, 120 (2d Cir. 1993) (reaffirming *Newman* interpretation of "in connection with" requirement).

[105] An important difference exists between the *Newman* court's conception of actionable 10(b) fraud, which would be extremely influential in later decisions, and Chief Justice Burger's view in *Chiarella*. Burger believed that a misappropriator had an absolute duty *to the contemporaneous trader* to disclose the information, and, in failing to do so, defrauded the trader. See *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting). The *Newman* court, however, considered the misappropriator's fraud *on the source of the information* to be the act that triggered the antifraud provisions. See *Newman*, 664 F.2d at 17-18; see also Aldave, supra note 62, at 115 n.76 (discussing Second Circuit's rejection of "the Chief Justice's version of the misappropriation theory").

[106] See SEC v. Clark, 915 F.2d 439, 444-54 (9th Cir. 1990) (applying *Newman* misappropriation analysis to case in which defendant received tip on upcoming tender offer).

[107] See SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991). *Cherif* marked an unprecedented extension of the theory, because the defendant was not in a fiduciary relationship with either the contemporaneous traders or the source of his information. After he was terminated from his employment at First National Bank of Chicago, defendant Cherif figured out how to reactivate his security pass so that he could enter the bank's offices at night. See id. at 406. While there, he discovered information on merger and leveraged buyout activity by the bank's clients, and made almost a quarter million dollars by trading in the target firms' securities. See id. at 406-07. While the misappropriation theory did not require that the insider stand in a fiduciary relationship with a purchaser or seller of securities, it clearly required that the insider breach a fiduciary duty owed to *someone*. Remarkably, the court seemed untroubled by the fact that, because the misappropriation of information and subsequent trading all took place *after* Cherif's employment with the bank had ended, he did not owe a fiduciary duty to the bank at the time. Drawing support from the "common sense notion of fraud behind the misappropriation theory," id. at 410, the court declared that Cherif's theft amounted to a breach of a "continuing duty" to his employer even after his employment had ended. Id. at 411.

[108] The Second Circuit faced the difficult issue of private rights of action by contemporaneous traders under the misappropriation theory in Moss v. Morgan Stanley Inc., 719 F.2d 5 (2d Cir. 1983), a shareholder derivative suit for damages arising from the scheme involved in the *Newman* criminal proceeding. In a previous case, the Second Circuit had

The Second Circuit would next face one of the most important cases in the short history of the misappropriation theory, *United States v. Carpenter*.[109] This was the first case, the court would later write, that was "clearly beyond the pale of the traditional theory of insider trading."[110] It involved a scheme in which R. Foster Winans, a reporter who sometimes wrote the *Wall Street Journal*'s "Heard on the Street" column, traded on advance information about the companies profiled in upcoming columns.[111] The trial court convicted Winans of violating 10(b), and the Second Circuit affirmed.[112] The decision is novel because Winans's employer, the *Wall Street Journal*, was not in a fiduciary relationship with any of the firms in which Winans purchased or sold securities. Therefore, because the *Journal* was the source of the inside information and the (nominally) defrauded party,[113] the fraud at issue was almost completely disconnected from the traded companies. While the *Newman* court had already concluded that the

extended private rights of action to shareholders in traditional insider trading cases, since the shareholder was the actual victim of the securities fraud violation. See Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 237 (2d Cir. 1974) (allowing shareholders' damages action against insider trader in nonmisappropriation case). The matter was not so simple in the misappropriation context, however, after *Newman* dispensed with the "purchaser or seller" rule and grounded 10(b) convictions on the breach of fiduciary duty owed to the informational source. See *Newman*, 664 F.2d at 17. The *Moss* court could not reconcile the doctrinal awkwardness of allowing a private right of action to a party who was not the ostensible victim of the securities fraud violation at issue; therefore, it did not allow the class to proceed. See *Moss*, 719 F.2d at 13 ("Nothing in our opinion in *Newman* suggests that an employee's duty to 'abstain or disclose' with respect to his employer should be stretched to encompass an employee's 'duty of disclosure' to the general public."). *Moss*'s sensible holding was invalidated five years later when Congress passed the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA), Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified in scattered sections of 15 U.S.C.). The act contained an amendment to section 20(a) of the Exchange Act that provided for a private right of action for contemporaneous traders, even under the misappropriation theory. See id., 102 Stat. at 4680 (codified at 15 U.S.C. § 78t-1(a) (1994)). While it is beyond doubt that *Moss* was consequently overruled, the congressional fiat does not provide an answer to the troubling doctrinal problems pointed out by that court. See infra Part III.B (discussing misappropriation theory's doctrinal incompatibility with private rights of action).

109 791 F.2d 1024 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987).

110 United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (en banc).

111 See *Carpenter*, 791 F.2d at 1026. The *Wall Street Journal* had an internal policy, of which Winans was aware, prohibiting employees from divulging the content of future articles. See id. Because the information in the *Journal* column usually impacted the price of the profiled companies' securities, Winans and his accomplices were able to earn nearly $690,000 by trading before publication. See id. at 1027.

112 See id. at 1026.

113 See id. at 1028 (holding that Winans breached duty of confidentiality to *Journal*). Professor Macey argues that the *Wall Street Journal*'s journalistic integrity was damaged by Winans's fraud. See Jonathan R. Macey, From Fairness to Contract: The New Direction of the Rules Against Insider Trading, 13 Hofstra L. Rev. 9, 43 (1984).

defrauded party need not be a purchaser or seller of securities,[114] here the circuit advanced a rule that the fraud itself need not bear a direct connection to a purchase or sale of securities.[115] The Supreme Court granted certiorari, but reached a four-four deadlock as to the validity of the misappropriation theory.[116] The circuit court's ruling was therefore affirmed.[117]

The Supreme Court's failure to hand down a definitive ruling on the misappropriation theory in *Carpenter* precipitated a backlash. In *United States v. Bryan*,[118] the Fourth Circuit became the first to reject the misappropriation theory.[119] The court took issue with its sister circuits' acceptance of the theory on two grounds: (1) the theory's broad definition of 10(b)'s "deceptive device" requirement, and (2) the theory's interpretation of 10(b)'s "in connection with the purchase or sale of any security" requirement.[120]

The court began by noting that Rule 10b-5 fraud can be defined no more broadly than section 10(b)'s prohibition of "deception . . . in connection with the purchase or sale of any security."[121] Therefore

114 See United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (reasoning purchaser or seller requirement concerned only standing to sue); see also supra note 103 and accompanying text. In *Newman*, unlike *Carpenter*, the source of the nonpublic information (the investment bank) was a fiduciary of the firms in whose securities the defendants traded. See *Newman*, 664 F.2d at 15 (discussing informational source's position as investment banker for involved companies).

115 Noting that 10(b)'s proscription extends to all "'"manipulative and deceptive practices which have been demonstrated to fulfill no useful function,"'" *Carpenter*, 791 F.2d at 1030 (quoting SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (quoting S. Rep. No. 73-792, at 6 (1934))), the court reasoned that "those who purchased or sold securities without the misappropriated information would not have purchased or sold, at least at the transaction prices, had they had the benefit of that information. . . . [I]nvestors are endangered equally by fraud by noninside misappropriators as by fraud by insiders." Id. at 1032. In response, Professor Langevoort argues that, while it is true that investors are harmed in either case, such a view "subordinates the deception requirement to a more central objective of combating *unfairness* in securities trading." Langevoort, supra note 3, at 189.

116 See Carpenter v. United States, 484 U.S. 19, 24 (1987). Justice Powell (the author of the *Chiarella* and *Dirks* majority opinions), who had recently retired, did not participate in the case.

117 See id. The Court also unanimously affirmed the convictions for wire and mail fraud. See id.

118 58 F.3d 933 (4th Cir. 1995).

119 See id. at 944. The facts of *Bryan* are as follows: In 1991, West Virginia officials decided that the state should expand its video lottery system and began accepting bids from service providers. See id. at 937-38. Defendant Bryan, the Director of the Lottery, favored Video Lottery Consultants ("VLC") and unlawfully manipulated bidding procedures to ensure that VLC would win the contract. See id. at 938-39. He was convicted on charges of wire fraud, mail fraud, perjury, and, because he purchased shares of VLC's stock, securities fraud under the misappropriation theory. See id. at 936.

120 See id. at 943-45 (discussing doctrinal objections to *Newman* and progeny).

121 Id. at 945; see also Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173 (1994) ("With respect . . . to . . . the scope of conduct prohibited by

the key question became whether the term "deception" could be read to include "breaches of fiduciary duty involving the misappropriation of confidential information from one who is neither a purchaser nor seller of securities, or otherwise connected with a securities transaction."[122]

The court, after analyzing the Supreme Court's interpretations of "deception," concluded that a material misrepresentation or nondisclosure was required to implicate 10(b).[123] Citing the Court's opinion in *Santa Fe Industries*, the Fourth Circuit held that a mere fiduciary breach to a party unrelated to the firm in whose securities the defendant traded would not amount to a deceptive act so defined.[124] "In essence," the court concluded, "the misappropriation theory disregards the specific statutory requirement of deception, in favor of a requirement of a mere fiduciary breach . . . ."[125]

Furthermore, the court held, the misappropriation theory failed to meet the "in connection with a purchase or sale of any security" nexus requirement of section 10(b).[126] Pointing out that the statute was intended to protect purchasers and sellers of securities (and not informational sources), the court concluded that 10(b)'s reach could not extend to cases in which no purchaser or seller had been defrauded: "It is only the breach of a duty to these persons that can give rise to a criminal conviction under section 10(b), if the statutory re-

§ 10(b), the text of the statute controls our decision."); Chiarella v. United States, 445 U.S. 222, 234 (1980) ("As we have emphasized before, the 1934 Act cannot be read ""more broadly than its language and the statutory scheme reasonably permit."'" (quoting Tocuhe Ross & Co. v. Redington, 442 U.S. 560 (1979) (quoting SEC v. Sloan, 436 U.S. 103, 116 (1978)))); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (noting that scope of Rule 10b-5 cannot exceed power Congress granted SEC under section 10(b)). The *Bryan* court also noted the Supreme Court's resistance toward broad interpretations of the securities laws. See *Bryan*, 58 F.3d at 945 ("For at least two decades, however, the Supreme Court has repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of the Act reasonably will bear.").

122 *Bryan*, 58 F.3d at 946. The court dealt with 10(b)'s deception requirement, and not "manipulation," because manipulation, as a "term of art," would involve specific wrongful acts clearly not at issue in the case. Id. at 945-46; see also supra note 79 and accompanying text (discussing definition of "manipulation").

123 See *Bryan*, 58 F.3d at 946. In Santa Fe Industries v. Green, 430 U.S. 462, 474 (1977), the Supreme Court defined the "deception" proscribed in section 10(b) as the making of a material misrepresentation or the nondisclosure of material information. See id. at 474.

124 The Court stated:

> Indeed, the Court in *Santa Fe Industries* specifically rejected the notion that a breach of fiduciary duty, in and of itself, is prohibited by section 10(b) [since not] 'all breaches of fiduciary duty in connection with a securities transaction' [come within the ambit of Rule 10b-5]. . . . [There must also be] 'manipulati[on] or decepti[on].'

*Bryan*, 58 F.3d at 945-46 (quoting *Santa Fe Indus.*, 430 U.S. at 472-74).

125 Id. at 950.

126 See id. at 946.

quirement that the fraud be in connection with the purchase or sale of securities is not to be rendered meaningless."[127]

In a bold summation, the court criticized the theory's similarity to an equal access rule:

> In allowing the statute's unitary requirement to be satisfied by any fiduciary breach (whether or not it entails deceit) that is followed by a securities transaction (whether or not the breach is of a duty owed to a purchaser or seller of securities, or to another market participant), the misappropriation theory transforms section 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships.[128]

A stronger blow could scarcely have been struck on behalf of *Chiarella* and its duty model. Its vindication, however, was short-lived—in *United States v. O'Hagan*,[129] decided just two years later, the Supreme Court would once again address the misappropriation theory, this time with a different result.

### *B.* United States v. O'Hagan

James O'Hagan, an attorney, worked for a law firm retained by Grand Met PLC regarding its acquisition of the Pillsbury Company.[130] Though not working on the matter, O'Hagan learned of Grand Met's upcoming tender offer for Pillsbury and purchased securities and option contracts in Pillsbury prior to its announcement.[131] When the stock rose, O'Hagan pocketed over four million dollars in profits from his trading.[132] He was convicted of 57 counts of mail fraud, money

[127] Id.; see also id. at 950 ("[T]he theory effectively eliminates the requirement that a person in some way connected to a securities transaction be deceived . . . ."). The *Bryan* court pointed to several instances, see id. at 946-47, in which the Supreme Court suggested that the defrauded party must be a purchaser or seller of securities. See, e.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173-74 (1994) (noting "broad congressional purpose" of Act is "to protect *investors* from false and misleading practices that might injure them" (emphasis added)); Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983) ("[A] violation [of section 10(b)] may be found only where there is 'intentional or willful conduct designed to deceive or defraud *investors*.'" (emphasis added) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976))); *Santa Fe Indus.*, 430 U.S. at 476-77 (stating purpose of prohibition on manipulation as protecting investors from being misled).

[128] *Bryan*, 58 F.3d at 950.

[129] 117 S. Ct. 2199 (1997).

[130] See United States v. O'Hagan, 92 F.3d 612, 614 (8th Cir. 1996), rev'd, 117 S. Ct. 2199 (1997).

[131] See id.

[132] See id.

laundering, and securities fraud.[133] The Eighth Circuit adopted the reasoning of *Bryan* entirely[134] and reversed each of the convictions.[135]

The Supreme Court granted certiorari, and in an opinion joined by five other justices, Justice Ginsburg reversed the Eighth Circuit and endorsed the misappropriation theory.[136] The Court addressed the circuits' criticisms of the theory in turn. First, regarding 10(b)'s requirement of deception in the form of a material misrepresentation or nondisclosure, the Court reasoned that misappropriators "deal in deception. A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain dupes' or defrauds the principal."[137] The Court had little hesitation in calling misappropriation a species of fraud, "akin to embezzlement."[138]

The Court also found that the theory satisfied the "in connection with" requirement because "the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide."[139] The majority did not consider the theory's grasp to be too wide-ranging under such an interpretation of 10(b), reasoning that

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133 See id.

134 See id. at 620 ("We find the analysis from *Bryan* persuasive and have borrowed heavily from it in arriving at our conclusion. Therefore, we adopt that court's analysis in its entirety as our own.").

135 See id. at 628. Like the Fourth Circuit, the court found that "[b]y its very definition, [the misappropriation theory] does not require either a material misrepresentation or nondisclosure," and thus does not satisfy section 10(b)'s "deception" requirement. Id. at 618. Moreover, "[b]y evading the statutorily required nexus that the fraud be 'in connection with the purchase or sale of any security,' the misappropriation theory essentially turns § 10(b) on its head." Id. at 619.

136 See United States v. O'Hagan, 117 S. Ct. 2199 (1997). Justice Thomas and Chief Justice Rehnquist dissented. See infra note 139 (discussing dissenting opinion). The Court noted that *Chiarella* did not foreclose its endorsement of the misappropriation theory. See *O'Hagan*, 117 S. Ct. at 2212.

137 Id. at 2208 (quoting Brief for United States at 17).

138 Id.

139 Id. at 2209; see also id. at 2212 ("The Court did not hold in *Chiarella* that the *only* relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders."). Justice Thomas's dissent, which Chief Justice Rehnquist joined, took issue with the majority's argument that the act of fraud in misappropriating inside information cannot be consummated until the misappropriator has used the information to trade in securities. If this were so, presumably a trader who misappropriates money to trade in securities could not be held liable because money need not be used solely to purchase securities, and thus is not necessarily consummated by the securities trading. See id. at 2223 (Thomas, J., concurring in part and dissenting in part). Justice Thomas found the fact that liability would therefore hinge on whether "the property being embezzled has value 'apart from [its] use in a securities transaction'" to suggest the incoherence of the theory. Id. at 2222 (quoting Brief for United States at 24

> [t]he misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities. . . . The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.[140]

The Court justified its interpretation of the "in connection with" language by pointing to the "animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."[141]

And so the misappropriation theory gained the endorsement its supporters had sought since *Chiarella*.[142] Several commentators, skeptical that *O'Hagan* represents an unqualified rule, have noted that the particularly egregious facts of the *O'Hagan* case (involving millions of dollars in profits) provided an exceptional opportunity for the SEC and Justice Department to seek the Court's endorsement.[143] The ruling is unequivocal, however, and the theory seems destined for a prosperous life.[144] Justice Ginsburg's opinion alluded to normative issues of fairness supporting the theory[145]—issues which, if regarded

n.13). Moreover, there is little reason to believe that misappropriated information itself could not be used to consummate fraudulent acts that have nothing to do with securities trading; for example, the misappropriator could sell the information to a newspaper for publication. See id. at 2223.

140 Id. at 2209.

141 Id. at 2210.

142 In passing the Insider Trading and Securities Fraud Enforcement Act of 1988, discussed more extensively supra note 108, the congressional committee referred explicitly to the misappropriation theory: "[T]he misappropriation theory clearly remains valid in the Second Circuit . . . but is unresolved nationally. In the view of the Committee, however, this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5." H.R. Rep. No. 100-910, at 10 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6047. Despite the committee's endorsement, Congress did not codify the theory, allowing the Supreme Court to definitively decide the issue in *O'Hagan*.

143 See Dominic Bencivenga, The Right Set of Facts: '*O'Hagan*' Court Affirms SEC Rule-Making Power, N.Y. L.J., July 3, 1997, at 5 (suggesting egregious facts of *O'Hagan* presented unique opportunity for SEC); William E. Donnelly & Thomas J. McGonigle, Ringing Endorsement of the Misappropriation Theory Sets Stage for Wide-Ranging Prosecution of Insider Trading, Legal Times, July 14, 1997 at S50 (same).

144 See Stan Crock, Insiders, Watch Your Backs: A High Court Ruling Sharpens the SEC's Enforcement Power, Bus. Wk., July 7, 1997, at 47 (quoting SEC official William R. McLucas as calling *O'Hagan* "the biggest victory for [the agency] in 15 years").

145 See *O'Hagan*, 117 S. Ct. at 2210 ("An investor's informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill." (citing Barbara Bader Aldave, Misappropriation: A General Theory of Liability for Trading on Nonpublic Information, 13 Hofstra L. Rev. 101, 122-23 (1984); Victor Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 356 (1979))).

as fundamental objectives of section 10(b) and Rule 10b-5, could change the face of insider trading regulation completely.

## III
## The Misappropriation Theory's Place in Existing Doctrines

The misappropriation theory rests on the awkward contrivance of grounding insider trading liability on fraudulent activity against a party wholly unrelated to the trading at issue: the source of the non-public information. The idea is counterintuitive to be sure—why should the federal government and the SEC be concerned with commonplace disputes between employers and their employees? How do federal prosecutions for such breaches of trust further the long-understood justifications for insider trading regulation—most importantly, the protection of investor confidence in the fairness of the financial markets?[146]

While the doctrinally sound fiduciary duty model focused on a breach of duty to the investor, the misappropriation theory clumsily attaches liability to fraudulent activity that has nothing to do with the purchase or sale of securities, and in which the contemporaneous trader has no interest whatsoever. The natural assumption, of course, is that the misappropriative fraud perpetrated against the informational source is, at best, secondary to the fact that the misappropriator profited from information that was not equally accessible to contemporaneous traders. Because the general public had no lawful means of discovering the information, the argument goes, the parties with whom the misappropriator traded were cheated, implicating the securities laws. This rationale seems superficially attractive, but cannot be squared with either the Supreme Court's pre-*O'Hagan* jurisprudence or the language of section 10(b).

This Part first examines the inconsistencies between the misappropriation theory and the Court's previous interpretations of the language of section 10(b) and Rule 10b-5. The fact that misappropriative fraud satisfies neither the statutory requirement of deceit,[147] nor the jurisdictional nexus requirement,[148] illustrates the peripheral relationship of such fraud to the key determination of whether the *subsequent*

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146 See supra notes 28-30 and accompanying text (discussing fairness rationales for insider trading regulation).

147 Section 10(b) requires that the wrongdoer utilize a "deceptive device or contrivance." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994); see supra note 32 and accompanying text (discussing deceit requirement); infra Part III.A.1 (same).

148 Section 10(b) requires that the deceptive device be utilized "in connection with the purchase or sale of any security." Securities Exchange Act of 1934 § 10(b), 15 U.S.C.

*trading* violated section 10(b). The Part goes on to demonstrate that, were the Court to take seriously the trader's fraud against the informational source, such reasoning would lead to serious disparities in the enforcement tools and remedies (i.e., private rights of action and secondary liability for employers) available under classical and misappropriation-type cases. The Part concludes by arguing that the misappropriation theory's similarities with the equal access model illustrate its doctrinal incoherence, and suggests that both be discarded in favor of the *Chiarella* Court's fiduciary duty analysis.

### A. *The Misappropriation Theory's Inconsistency with Statutory Requirements*

The Court has rejected the equal access theory in favor of its *Chiarella* fiduciary duty model, holding that an equal access rule would deviate dramatically from the common law doctrines involving fiduciary relationships.[149] Though it purportedly honors *Chiarella*'s requirement of a fiduciary breach, the misappropriation theory possesses nearly identical problems: It stretches the statutory requirement of "deceit," which must be practiced "in connection with the purchase or sale of any security," too far. More precisely, misappropriation, like the equal access theory, is premised on the notion of creating an actionable fraud out of silence where there is no duty to speak.

#### 1. *Deceit*

The *Chiarella* Court interpreted section 10(b)'s requirement of a "deceptive device" in light of the common law understanding of the term "deceit," defined as nondisclosure in the face of a duty to disclose.[150] Because a party is not under a duty to disclose information absent some special relationship imposing such a duty,[151] the Court considered the existence of a fiduciary relationship between traders a necessary predicate to establishing deceit in the insider trading context.[152] The *O'Hagan* Court, on the other hand, premised liability on

§ 78j(b) (1994); see supra note 32 and accompanying text (discussing "in connection with" requirement); infra Part III.A.2 (same).

149 See Dirks v. SEC, 463 U.S. 646, 657-58 (1983) (pointing out doctrinal weaknesses of equal access model); Chiarella v. United States, 445 U.S. 222, 233 (1980) (same); see also supra notes 82-83, 89 and accompanying text (outlining Court's disapproval of equal access model).

150 See *Chiarella*, 445 U.S. at 235 (discussing common law definition of deceit); see also supra note 80 and accompanying text (same).

151 See *Chiarella*, 445 U.S. at 228 (discussing duty to disclose); see also supra note 74 and accompanying text (same).

152 See *Chiarella*, 445 U.S. at 228 (adopting fiduciary duty rule).

the defendant's act of "'pretend[ing] loyalty to the [informational source] while secretly converting the . . . information for personal gain.'"[153] Such conduct, the Court reasoned, "'dupes' or defrauds the [source]."[154] Implicit in the *O'Hagan* Court's reasoning is a definition of actionable securities fraud as any fiduciary breach pursuant to a violation of trust owed to the informational source, not necessarily in violation of a duty of disclosure owed to the contemporaneous trader.[155]

Neither the misappropriation theory nor the equal access theory takes seriously section 10(b)'s requirement of deceit in their conceptions of actionable fraud.[156] Deceit was, and is, a precise term of art[157] used by the Court to refer to a species of fraud into which not all breaches of fiduciary duty fall.[158] Both models fallaciously assume that conduct not involving the breach of a duty to disclose to the contemporaneous trader, founded on a fiduciary relationship between the parties, can constitute deceit so defined. The theories rest on a view that trading on confidential information is itself a form of deceit: in

153 United States v. O'Hagan, 117 S. Ct. 2199, 2208 (1997) (quoting Brief for United States 17).

154 Id.; accord United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987) (holding liable misappropriator whose informational source was not in fiduciary relationship with issuer of traded securities).

155 The *O'Hagan* majority did not contend that a duty to disclose the nonpublic information to the contemporaneous trader was created by the act of misappropriation.

156 In an equal access regime, of course, the actionable deception is simply the act of trading on inside information that is inaccessible to contemporaneous traders. See United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978) ("*Anyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."), rev'd, 445 U.S. 222 (1980); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 838 (2d Cir. 1968) (en banc) (holding relationship of defendants to contemporaneous traders immaterial to insider trading liability).

157 See Santa Fe Indus. v. Green, 430 U.S. 462, 474 (1977) (defining deceit as material misrepresentation or material failure to disclose); see also supra note 80 and accompanying text (discussing common law definition of deceit). This point seems to have been overlooked by many commentators, who use the term "deceit" to refer to wrongdoing in general. One recent case comment on the *O'Hagan* decision begins its analysis of "deceit" with a definition from Webster's Dictionary. See The Supreme Court, 1996 Term—Leading Cases, 111 Harv. L. Rev. 197, 417 (1997). Such vague references ignore the fact that the Court has used the term "deceit" as a term of art with a precise meaning in the common law. In his recent comment on *O'Hagan*, Professor Brudney also uses the term "deceit" loosely. He claims that trading on misappropriated information "operates as a fraud or deceit upon [the contemporaneous trader] as much as does a similar failure to disclose by a fiduciary." Victor Brudney, O'Hagan's Problems, 1997 Sup. Ct. Rev. 249, 256.

158 See United States v. Bryan, 58 F.3d 933, 946 (4th Cir. 1995) (noting that "Court in *Santa Fe Industries* specifically rejected the notion that a breach of fiduciary duty, in and of itself, is prohibited by section 10(b)"). The *Santa Fe Industries* Court was clear in stating that deceit involves conduct beyond the realm of mere fiduciary breach—namely, misrepresentation or a material failure to disclose. See *Santa Fe Indus.*, 430 U.S. at 474.

the misappropriation context, because it has been stolen or converted; in equal access, because it is inaccessible.[159] Both take the doctrinally untenable step of disregarding whether the trader was under a fiduciary obligation to disclose the nonpublic information to the contemporaneous trader.

As the *Chiarella* and *Dirks* Courts noted, the text of section 10(b) provides little support for an interpretation of deceit that includes nondisclosure to a market trader where no disclosure was required.[160] Nevertheless, some supporters of the misappropriation/equal access view have argued that to limit the proscribed "deceptive" conduct to that perpetrated by wrongdoers in a fiduciary relationship with their victims would thwart legislative intent.[161] Because section 10(b)'s prohibition extends to the deceptive devices of "any person," the argument can be made that the statute "is addressed to some other mode of limiting required disclosure of information than by focusing on the special relationship of the parties."[162]

While Congress did intend to maximize section 10(b)'s usefulness as a catchall provision by extending its reach to "any person," that language should not be read in a vacuum. Rather, it must be consid-

159 Herein lies the only difference in liability under the misappropriation and equal access models. The misappropriation theory would spare a trader who used nonpublic information if the trader disclosed (to the source) such use or otherwise did not fraudulently obtain the information; the equal access model would not. *O'Hagan* still demands a breach of duty; however, it is satisfied if the breach is perpetrated against the source of the information. One is left to wonder why *O'Hagan* would leave this door open. The *Chiarella* Court had good reason to require a breach of fiduciary duty—such a relationship established a common law duty to disclose nonpublic information to the contemporaneous trader. In the misappropriation theory context, however, a duty to disclose is never established (except, of course, the trader's duty to disclose her misappropriation to the source) because the relationship of the traders is completely irrelevant. The Court determined in *O'Hagan* that trading on nonpublic information is actionable *despite the lack of a duty to disclose*; it is the fact that the information was wrongfully obtained that makes the trader culpable. If the fiduciary breach is no longer necessary to establish a duty to disclose (because such a duty itself is no longer a necessary predicate to liability), why demand a breach at all? Surely trading on nonpublic information utilized with the approval of the source is every bit as harmful to the unknowing investor as trading on unlawfully obtained information.

160 See, e.g., Dirks v. SEC, 463 U.S. 646, 660 (1983) (reaffirming duty rule); Chiarella v. United States, 445 U.S. 222, 235 (1980) ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

161 See Brudney, supra note 157, at 253-54 (arguing that Congress intended section 10(b)'s reach to extend beyond fraud by fiduciaries).

162 Id. at 253. Brudney also contends that, because other provisions of the Exchange Act refer to specific relationships such as insider-stockholder or broker-client, by negative inference one must conclude that Congress sought "to regulate the behavior of all kinds of players . . . (including unscrupulous market operators who could not conceivably be deemed fiduciaries), not simply focusing on the agency obligations of corporate insiders." Id. at 254.

ered in light of the statute's requirement that the "person" employ a "deceptive device," which occurs only when the person had a fiduciary obligation to disclose the information.[163] Congress, by its use of the term deceit, did in fact limit the required disclosure "by focusing on the special relationship of the parties."[164] To argue otherwise is to assume that Congress intended to equate deceit with wrongdoing in general; the Supreme Court, however, has been clear that such an interpretation would be overinclusive.[165]

### 2. *"In Connection With the Purchase or Sale of Any Security"*

In its pre-*O'Hagan* duty model cases, the Supreme Court rightly suggested that the "in connection with" nexus requirement demanded that the fraud be perpetrated against a purchaser or seller of securities.[166] The misappropriation theory, however, vastly broadens this interpretation to include acts perpetrated against the source of nonpublic information that are ultimately consummated in securities trades.[167] The *O'Hagan* Court thereby sanctioned liability in situations in which, conceivably, no investor or market participant was the target of the actionable fraud.[168]

This indicates that not only is the misappropriative fiduciary breach unnecessary to establish a duty to disclose, but also that its relationship to the wrongful trading is tenuous at best. It is only this slender strand of reasoning, the requirement of a distantly related, wholly unnecessary breach, that separates the misappropriation theory from an equal access regime (in which the duty is owed directly to the contemporaneous trader).[169] While the Court's endorsement of the theory seems, in a nominal way, to retain *Chiarella*'s requirement of a fiduciary breach, the breach required for an ultimate finding of liability is peripheral and doctrinally superfluous.

Some commentators, recognizing this "in connection with" difficulty, seek to remedy the problem by encouraging the Court to take

163 See *Chiarella,* 445 U.S. at 228 (reasoning that nondisclosure is actionable only when trader was under fiduciary duty to disclose); see also supra notes 73-74 and accompanying text.

164 Brudney, supra note 157, at 253.

165 See supra notes 157-58 and accompanying text (discussing common law definition of deceit).

166 See supra note 127 (discussing case support for "purchaser or seller" rule).

167 See United States v. O'Hagan, 117 S. Ct. 2199, 2209-11 (1997) (discussing "in connection with" requirement); accord United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987) (same).

168 See United States v. Bryan, 58 F.3d 933, 950 n.17 (4th Cir. 1995) (criticizing sister circuits' disposal of purchaser or seller rule).

169 See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) (en banc) (imposing general duty among all traders to disclose nonaccessible material information).

the further step of recognizing that the contemporaneous trader is defrauded when another trader transacts on the basis of misappropriated information.[170] They argue that because market traders "expect that trading is conducted on the basis of information obtained in compliance with the law, the exploitation of stolen information is fraudulent."[171] This argument must fail, however, for the familiar reason that such "fraudulent" (assuming that it may be characterized as such) conduct would not constitute deceit.[172] The trader's activity would be deemed a deceptive device only if the trader were obligated to disclose the illegitimately-obtained information to the opposite party. Absent a fiduciary relationship between the parties (which would obviate the need to proceed under the misappropriation theory in the first place), such an obligation cannot be found to exist.

### B. *The Relevant (and Irrelevant) Fraud Under the Misappropriation Theory*

Because of its distant relation to the wrongful trading, misappropriative fraud appears to be little more than an instrumentality through which the government can combat unfair trading practices by means of the long arm of the misappropriation theory. The only way for the Court to refute such an argument would be to take the misappropriator's fraud against the source of the information seriously, and not just as a convenient vehicle with which the Court can enforce a general duty to disclose nonpublic information to all investors. The breach of the duty to the source of the information, and not the subsequent unfair trading activity, must be seen as an animating purpose of section 10(b), i.e., the evil to be prevented by the insider trading laws. If we assume that this is so, what is the result? Such reasoning leads to strange consequences: namely, the elimination of both private rights of action (at least in theory)[173] and secondary liability for employers[174] in misappropriation theory cases. One would also question

170 See, e.g., Brudney, supra note 157, at 256-57; The Supreme Court, 1996 Term—Leading Cases, supra note 157, at 418-21. Such an argument is similar to that advanced by Chief Justice Burger in his *Chiarella* dissent. See Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting). The *O'Hagan* Court clearly rejected such a theory, noting that "[t]he Government does not propose that we adopt a misappropriation theory of that breadth." *O'Hagan*, 117 S. Ct. at 2208 n.6; see also id. at 2211 n.9 (reasoning that if misappropriator had revealed trading plans to source, subsequent trading would not have constituted securities fraud).

171 The Supreme Court, 1996 Term—Leading Cases, supra note 157, at 418.

172 See supra Part III.A.1 (discussing deceit requirement of section 10(b)).

173 See infra notes 179-179 and accompanying text (discussing private rights of action in misappropriation theory context).

174 See infra notes 183-190 and accompanying text (discussing secondary liability actions in misappropriation theory context).

the doctrinal justifications for implicating the securities laws (and usurping applicable state law) in garden-variety cases of theft.[175]

This goes to suggest that the Court did not, in fact, intend such illogical disparities in remedies and doctrine. It should thus acknowledge that its endorsement of the misappropriation theory was tantamount to an endorsement of the equal access doctrine, and take the dubious step of recognizing a duty among all shareholders to disclose nonpublic information. If the Court, on the other hand, intends to adhere to its sensible rejection of the equal access doctrine, it should recognize that it cannot maintain this stance and also support the misappropriation theory.

In *Chiarella*'s fiduciary duty model, it was not only clear that the existence of a fiduciary relationship established the insider's duty to disclose, but also that the breach of that duty was exactly the type of fraud the securities laws were intended to prevent. When a securities trader intentionally deceives another trader entitled to rely on her honesty as a fiduciary, a system of investor protection such as the Exchange Act's antifraud provisions is implicated. The deterrent effects of the duty regime harmonize completely with the animating purpose of section 10(b). The misappropriation theory, on the other hand, calls upon the securities laws whenever a trader breaches a fiduciary duty owed to the source of any nonpublic information. Such acts, though wrongful, do not implicate the antifraud provisions in the same way—surely section 10(b) was not motivated by a desire to deter what would be, in any other context, common law theft.

If this were not so, one would wonder why the Supreme Court deemed existing law inadequate to combat misappropriation in the securities context.[176] State criminal laws prohibit theft, which would be an element in every misappropriation case, as well as embezzlement and conversion of corporate assets. Federal mail and wire fraud statutes would also be implicated in many cases.[177] As one commen-

[175] See infra notes 176-78 and accompanying text (discussing misappropriation theory's encroachment on traditional province of state law).

[176] See Fisch, supra note 3, at 207-08 (arguing that state law is adequate to address most kinds of informational misappropriation); Gary Lawson, The Ethics of Insider Trading, 11 Harv. J. L. & Pub. Pol'y 727, 767 (1988) (same).

[177] For example, Judge Dumbauld, writing in dissent in United States v. Newman, 664 F.2d 12 (2d Cir. 1981), reasoned that the mail fraud statute was sufficient to cover the defendant's misappropriative fraud. See id. at 20-21 (Dumbauld, J., dissenting). Indeed, James O'Hagan himself was prosecuted on counts of mail fraud and money laundering in addition to securities fraud. See United States v. O'Hagan, 117 S. Ct. 2199, 2205 (1997). The mail fraud statute prohibits the use of the mails in "any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . . ." 18 U.S.C. § 1341 (1994).

tator correctly points out, "[f]ederal securities laws are not needed to protect employers from theft."[178]

Further, even assuming section 10(b) to be the more apt vehicle for combating misappropriative fraud, there would be important inconsistencies in the enforcement tactics available under the fiduciary duty and misappropriation models. For example, it should be clear that the availability of civil damage actions to contemporaneous traders would be wholly incongruous with the structure of the misappropriation theory. Particularly in the context of violations of section 10(b), the private right of action has served as an important ancillary enforcement mechanism for the SEC and Justice Department.[179]

In a misappropriation case, however, the defrauded party is the informational source, not the trader. A party who has not been defrauded under the general theory of liability should not have standing to bring an action for damages.[180] In the Insider Trading and Securities Fraud Enforcement Act of 1988,[181] Congress provided such a right of action to private plaintiffs.[182] This fact does not, however, explain away the doctrinal awkwardness of the idea. In fact, Congress's action merely serves to illustrate the legislators' reluctance to accept the limitations of the fiduciary duty rubric, and their friendliness to a broader equal access regime.

The less obvious consequence of the misappropriation theory would be the elimination of secondary liability for employers. Secondary liability serves the important purpose of motivating employers to take appropriate preventive measures to deter their employees from committing securities fraud in the first place. Generally, the employer of a person liable for insider trading violations can be held derivatively liable for such violations under one of two theories. First, the employer may be liable as a "controlling person" under section 20(a) of the Exchange Act.[183] A controlling person is a party who, through

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178 Martin Kimel, Note, The Inadequacy of Rule 10b-5 to Address Outsider Trading by Reporters, 38 Stan. L. Rev. 1549, 1564 (1986).

179 See Michael J. Chmiel, The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Right of Action, 1990 U. Ill. L. Rev. 645, 646 (noting that private rights of action "provide[ ] the [SEC] more incentives and weapons to successfully pursue insider traders").

180 This is exactly what the Second Circuit recognized in Moss v. Morgan Stanley, Inc. 719 F.2d 5, 16 (2d Cir. 1983) (holding private rights of action do not lie for contemporaneous traders in misappropriation theory cases). See discussion of *Moss*, supra note 108.

181 Pub. L. No. 100-704, 102 Stat. 4677 (codified in scattered sections of 15 U.S.C.).

182 See Insider Trading and Securities Fraud Enforcement Act of 1998 § 5, 15 U.S.C. § 78t-1(a) (1994); see also supra note 108 and accompanying text (discussing ITSFEA).

183 Securities Exchange Act of 1934 § 20(a), 15 U.S.C. § 78t(a) (1994). Section 20(a) was amended in 1988 by ITSFEA to expand the scope of liability to "'controlling persons' who fail to take adequate steps to prevent insider trading." Insider Trading and Securities

stock ownership, agency, or agreement, controls the wrongdoer.[184] Significantly, a controlling person may escape liability if it can prove that the person "acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[185]

A second theory of secondary liability is the common law doctrine of respondeat superior.[186] In contrast to controlling person liability, this doctrine does not factor the good faith of the employer into the analysis.[187] The only elements required to establish liability are (1) that a true employment relationship existed between the trader and employer, and (2) that the trader was acting within the scope of her employment in committing the violations. The employer may be held secondarily liable for any conduct of the type the employee was employed to perform actuated by an intent to serve the master.[188] It is important to note that the circuits are not in accord as to the appli-

Fraud Enforcement Act of 1988, H.R. Rep. No. 100-910, at 7 (1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6044. Section 21(a) of the Exchange Act authorizes the SEC to seek the "greater of $1,000,000, or three times the amount of the profit gained or loss avoided." 15 U.S.C. § 78u-1(a)(3) (1994).

184 The statute speaks of "[e]very person who [controls] directly or indirectly" an insider trader being subject to liability. 15 U.S.C. § 78t(a) (1994). The legislative history of the statute designates "stock ownership, lease, contract or agency" as indicia of control. H.R. Rep. No. 73-1383, at 26 (1934). See generally Loftus C. Carson, II, The Liability of Controlling Persons Under the Federal Securities Acts, 72 Notre Dame L. Rev. 263, 273-75 (1997) (discussing determination of controlling person status).

185 15 U.S.C. § 78t(a) (1982); see also William H. Kuehnle, Secondary Liability Under the Federal Securities Laws—Aiding and Abetting, Conspiracy, Controlling Person, and Agency: Common-Law Principles and the Statutory Scheme, 14 J. Corp. L. 313, 363-66 (1988) (discussing good faith defense); J. Christopher York, Vicarious Liability of Controlling Persons: Respondeat Superior and the Securities Acts—A Reversible Consensus in the Circuits, 42 Emory L. J. 313, 322-24 (1993) (same). Courts usually will entertain a good faith defense if the employer did not have actual knowledge of the trading activity and reasonably supervised its employees. See, e.g., Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1576 (9th Cir. 1990) (holding reasonable supervision necessary to assertion of good faith); Sennott v. Rodman & Renshaw, 474 F.2d 32, 38-40 (7th Cir. 1973) (holding employer not liable due to lack of actual knowledge).

186 See Restatement (Second) of Agency § 216 (1957): "A master or other principal may be liable to another whose interests have been invaded by the tortious conduct of a servant or other agent, although the principal does not personally violate a duty to such other or authorize the conduct of the agent causing the invasion."

187 Respondeat superior is a type of strict liability, which makes the good faith of the employer irrelevant. See 10 William Meade Fletcher, Fletcher Cyclopedia of the Law of Private Corporations § 4877, at 338 (perm. ed. rev. vol. 1993) ("A corporation cannot defend against a tort claim on the ground that its agent or employee was not expressly authorized to commit the wrongful act . . . .").

188 See Restatement (Second) of Agency § 228 (1957); see also Kuehnle, supra note 185, at 367-69 (discussing agency liability).

cability of the doctrine in the insider trading context, given its potentially wider reach than controlling person liability.[189]

Secondary liability cannot be supported in the misappropriation theory context under the formal requirements of either the controlling person or respondeat superior doctrines. Taking *O'Hagan*'s conception of actionable fraud at face value, section 10(b)'s deception requirement is met only when an employee deceives her employer by depriving it of the exclusive use of its confidential information.[190] An employer cannot be held secondarily liable as a controlling person under section 20(a) because the employer will not have induced its employee to defraud itself, and thus it can be presumed to have acted in good faith in this regard. Additionally, a respondeat superior theory of liability will always be inappropriate because an employee cannot be acting within the scope of her employment when she is defrauding her employer. Once deception is proven in a lawsuit to establish the employee's liability, the prosecution could not retrench and argue that the employee was acting within the scope of her employment or that the employer actually induced the deception against itself. The misappropriation theory's unique feature, basing the securities fraud on the wrongful act directed against the informational source, would thereby protect the source from liability.

Private rights of action and secondary liability have been important enforcement tools for the SEC and the Justice Department throughout much of the life of insider trading regulation.[191] One is left to question what is so intrinsically different about misappropriation cases that makes their continuing availability inappropriate. Is the harm to private plaintiffs less great than in classical insider trading cases? Is the employer who fails to implement internal procedures to

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189 A minority of circuits have held that the respondeat superior doctrine was excluded by statute in section 20(a). If the common law doctrine were to be applied in the securities context, these courts argued, section 20(a)'s good faith exception would be effectively nullified. See, e.g., Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 884-86 (3d Cir. 1975); Zweig v. Hearst Corp., 521 F.2d 1129, 1132-33 (9th Cir. 1975). The majority of circuits apply the doctrine, reasoning that Congress did not intend to displace established common law principles. See, e.g., In re Atlantic Fin. Management, Inc., 784 F.2d 29, 31 (1st Cir. 1986); Paul F. Newton & Co. v. Texas Commerce Bank, 630 F.2d 1111, 1118-19 (5th Cir. 1980); Marbury Management, Inc. v. Kohn, 629 F.2d 705, 712-16 (2d Cir. 1980); Holloway v. Howerdd, 536 F.2d 690, 694-95 (6th Cir. 1976); Carras v. Burns, 516 F.2d 251, 259 (4th Cir. 1975); Kerbs v. Fall River Indus., 502 F.2d 731, 740-41 (10th Cir. 1974).

190 See United States v. O'Hagan, 117 S. Ct. 2199, 2208 (1997) (discussing defendant's misappropriative fraud against employer).

191 See, e.g., Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971) ("It is now established that a private right of action is implied under section 10(b)."); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 236 (2d Cir. 1974) (recognizing private right of action for contemporaneous traders in classical insider trading cases).

prevent insider trading in the workplace any less culpable? The answer must surely be no.

And yet, given the misappropriation theory's odd placement of the actionable breach of fiduciary duty, there is no room for either enforcement tool in its doctrinal framework. The rule, at least in theory, punishes those who perpetrate a fraud against their informational source, not against the parties with whom they trade. The traders are presumably merely the penumbral victims of the wrongful act at issue.

This conundrum highlights the obvious point that the contemporaneous traders are not the penumbral, but rather the *primary*, victims for whom the misappropriation theory was created. The breach of duty against the informational source is not at all the fraud with which the *O'Hagan* Court was concerned; taking this fraud seriously would displace existing law and make private rights of action and secondary liability doctrinally incompatible. Lurking in the background is an implicit duty owed directly to the contemporaneous trader. Explicit recognition of this implied duty would bring the misappropriation theory fully in line with the equal access model on which it rests.

Such a frank acknowledgment of the relationship of misappropriation to equal access would not come without costs, however, as the Court has heretofore recognized. The two theories put in place the same sort of broad duty of disclosure among all market participants that the Court soundly rejected in *Chiarella* and *Dirks*, not only because it discourages legitimate financial analysis, but also because it is plainly inconsistent with applicable statutory and common law. In those cases, the Court reasoned that the duty model, with its requirement of a fiduciary relationship and breach, better effectuated congressional intent and accommodated longstanding common law doctrine.

The choice facing the Court is simple: It may continue to endorse the misappropriation theory and accept its consequent evisceration of the duty model, or it may retreat from its *O'Hagan* rule and reassert the viability of *Chiarella*. This Note has argued that the latter would be the sounder choice as a matter of doctrine. Whatever the Court eventually does, however, it should recognize that it must choose—the misappropriation and fiduciary duty models, for the reasons discussed above, are not compatible. Absent an explicit retreat from one of these theories of liability, the Court's stance on insider trading regulation will remain fundamentally inconsistent, even incoherent.

## Conclusion

The present state of insider trading regulation is in disarray. In an attempt to reconcile two warring doctrines, the fiduciary duty and equal access models, the Supreme Court has settled on what it views to be a satisfactory middle ground, the misappropriation theory. The doctrinal footing for this result, however, is unsteady at best. The Court should acknowledge that, as a matter of statutory interpretation, it had it right with the *Chiarella* fiduciary duty model of liability. Absent explicit action by Congress, i.e., the codification of the misappropriation theory, the Court's decision in *O'Hagan* simply strays too far from *Chiarella*'s analysis. The misappropriation theory, like the equal access theory before it, rests on doctrine that finds little support in our regulatory tradition.