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Simplifying the Analysis: The Second Circuit Lays Out a Straightforward Theory of Fraud in *SEC v. Dorozhko**

INTRODUCTION

The conditions that led to the adoption of section 10(b) of the Securities Exchange Act of 1934[1] are eerily evocative of the atmosphere currently plaguing the national economy.[2] Since 2008 the United States has suffered through a stock market crash, an economic downturn, and a loss of investor confidence[3]—all market conditions that starkly mirror the events originally driving the enactment of section 10(b), a statute designed "to insure honest securities markets and thereby promote investor confidence."[4] As the current economy limps out of the "Great Recession,"[5] the need for fair and honest securities markets will be of paramount importance.[6] Consequently the need will also be great for regulatory agencies, specifically the Securities and Exchange Commission (SEC),[7] to have a clear and straightforward standard under which to pursue actors who engage in

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1. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006). The Act was necessary to restore investor confidence after the stock market crash of 1929. *See* SEC v. Zandford, 535 U.S. 813, 819 (2002) (quoting United States v. O'Hagan, 521 U.S. 642, 658 (1997)). For an overview of the parallels between the current recession and the Great Depression, see generally Miguel Almunia et al., *From Great Depression to Great Credit Crisis: Similarities, Differences and Lessons* (Nat'l Bureau of Econ. Research, Working Paper No. 15524, 2009).

2. *See* Justin Lahart, *The Great Recession: A Downturn Sized Up*, WALL ST. J., July 28, 2009, at A12.

3. *See* David Leonhardt, *Casualties of the Recession*, N.Y. TIMES, Mar. 4, 2009, at B1; David Zweig, *Will We Ever Again Trust Wall Street?*, WALL ST. J., Feb. 6, 2010, at B7.

4. United States v. O'Hagan, 521 U.S. 642, 658. The Court further expounded on the purpose behind section 10(b), stating that "[a]lthough informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law." *Id.*

5. Kurt Anderson, *The End of Excess: Is This Crisis Good for America?*, TIME (Mar. 26, 2009), http://www.time.com/time/nation/article/0,8599,1887728-1,00.html.

6. *See* Zweig, *supra* note 3.

7. 15 U.S.C. § 78d(a) (2006). The Securities and Exchange Commission was created as part of the Securities Exchange Act of 1934 "with an arsenal of flexible enforcement powers" for the "efficient regulation of securities trading." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

fraudulent behavior in securities markets—particularly as technology changes the very landscape of those markets.[8]

However, the principal antifraud statute, section 10(b), has become anything but straightforward, enduring a tortured existence as courts struggled to force different behaviors to fit into its mold.[9] Most notably, section 10(b) has been used to combat insider trading—traditionally defined as "[t]he use of material, nonpublic information in trading the shares of a company by a corporate insider or other person who owes a fiduciary duty."[10] The United States Court of Appeals for the Second Circuit therefore struck a progressive and potentially expansive victory for section 10(b)'s fundamental antifraud purpose in *SEC v. Dorozhko*.[11] The court held that liability under section 10(b) could be found upon a showing of an affirmative misrepresentation, regardless of whether a fiduciary duty existed.[12] The appellate court's decision directly overturned the lower court's determination that section 10(b) could not be violated without a breach of fiduciary duty.[13] Indeed, the significance of the Second Circuit's holding in *Dorozhko* is most aptly underscored by the district court's declaration that "[t]o eliminate the fiduciary requirement now would be to undo decades of Supreme Court precedent, and rewrite the law as it has developed."[14] Specifically, the Second Circuit's decision was contrary to *Regents of the University of*

8. *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.0[2], at 3–4 (rev. 5th ed. 2006).

9. *See* Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 881 (2009) ("The federal securities laws do not contain a definition of insider trading. As a result, case law has developed in a common law fashion from the broad statutory antifraud prohibitions. The result has been a tortuous path in defining the reach of the prohibition against trading securities on the basis of nonpublic information.").

10. BLACK'S LAW DICTIONARY 866 (9th ed. 2009).

11. 574 F.3d 42 (2d Cir. 2009).

12. *Id.* at 49–50.

13. SEC v. Dorozhko, 606 F. Supp. 2d 321, 324 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 ("Upon a searching review of existing case law . . . we believe that we are constrained to hold that [defendant's actions do] not amount to a violation of § 10(b) . . . because [defendant] did not breach any fiduciary or similar duty 'in connection with' the purchase or sale of a security.").

14. *Id.* at 323. The district court also posited that

> in the 74 years since Congress passed the Exchange Act, no federal court has *ever* held that the theft of material non-public information by a corporate outsider and subsequent trading on that information violates § 10(b). Uniformly, violations of § 10(b) have been predicated on a breach of a fiduciary (or similar) duty of candid disclosure that is 'in connection with' the purchase or sale of securities.

Id.

California v. Credit Suisse First Boston (USA), Inc.,[15] an earlier decision by the Fifth Circuit holding that "[a]n act cannot be deceptive within the meaning of § 10(b) where the actor has no duty to disclose."[16] By eliminating the need to show the existence of a fiduciary duty, the SEC is free to focus on all fraudulent behavior, regardless of the actor's particular relationships, thereby simplifying its burden and potentially broadening the scope of prohibited behavior.[17]

This Recent Development will argue that the Second Circuit was correct in its holding that an affirmative misrepresentation is a violation of section 10(b), regardless of whether a fiduciary duty is present.[18] To illustrate the point, the discussion of misrepresentation will focus on a computer hacker who misrepresents his identity to a computer to gain access to information. Part I will review *SEC v. Dorozhko*, contrasting the decision and reasoning of the Second Circuit with that of the district court it reversed. Part II will analyze the scope of section 10(b), beginning with its common law roots and overriding purpose and then exploring the Supreme Court's development of insider trading liability under the statute. Part III will explore the distinction between affirmative misrepresentations and abrogations of a duty to disclose, arguing that the Second Circuit

15. 482 F.3d 372 (5th Cir. 2007).

16. *Id.* at 386.

17. *See Second Circuit Holds That Computer Hacking for Purposes of Trading on Inside Information May Be a "Deceptive Device" Under Section 10(b) Even in the Absence of a Breach of Any Fiduciary Duty*, CORP. SEC. L. BLOG (Aug. 7, 2009), http://www.corporatesecuritieslawblog.com/securities-litigation-second-circuit-holds-that-computer-hacking-for-purposes-of-trading-on-inside-information-may-be-a-deceptive-device-under-section-10b-even-in-the-absence-of-a-breach-of-any-fiduciary-duty.html.

18. Pursuant to the rulemaking authority granted to it under section 10(b), the SEC enacted Rule 10b-5 in 1942. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); *see also* 17 C.F.R. § 240.10b-5 (2010) (delineating the unlawful manifestations of affirmative misrepresentation in securities transactions); *infra* Part II.B (discussing the purpose behind the enactment of section 10(b)). Although Rule 10b-5 is the means under which the SEC will most likely pursue insider trading cases involving an affirmative misrepresentation, the focus of this Recent Development will be section 10(b), since the scope of the Rule cannot exceed the power granted to the Commission under section 10(b). *See* SEC v. Zandford, 535 U.S. 813, 816 n.1 (2002) ("The scope of Rule 10b-5 is coextensive with the coverage of § 10(b) . . . ; therefore we use § 10(b) to refer to both the statutory provision and the Rule.") (citations omitted); United States v. O'Hagan, 521 U.S. 642, 651 (1997) ("Liability under Rule 10b-5 . . . does not extend beyond conduct encompassed by § 10(b)'s prohibition."); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) ("[I]n deciding whether a complaint states a cause of action for 'fraud' under Rule 10b-5, 'we turn first to the language of § 10(b).' " (quoting *Ernst & Ernst*, 425 U.S. at 197)); *Ernst & Ernst*, 425 U.S. at 214 ("[D]espite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b).").

correctly distinguished between the two theories based on Supreme Court precedent. It will then further examine the split between the Second and Fifth Circuits, ultimately deciding that the Second Circuit correctly defined "deceptive" as not requiring a fiduciary duty for all violations.[19] Part IV will further defend the straightforward theory of fraud through an analysis of the relevant case law surrounding the Second Circuit's decision and by addressing potential counterarguments. Finally, Part V will consider the future ramifications of the Second Circuit's decision, concluding that the court's new standard streamlines the section 10(b) analysis and furthers the statute's remedial, antifraud purpose.

I. *SEC v. DOROZHKO*

In *Dorozhko*, the defendant (Oleksandr Dorozhko) opened an online trading account with a brokerage firm and deposited $42,500 into the account,[20] just as IMS Health, a healthcare market research company,[21] announced it would release quarterly company earnings at a scheduled analyst conference call later in the month.[22] On the day IMS Health was to release its earnings, Dorozhko allegedly hacked into the secure server hosting IMS Health's financial data and downloaded the information.[23] Dorozhko then spent roughly the full amount in his account on "put" options[24] set to expire a week later.[25] By purchasing the put options, Dorozhko would profit greatly if IMS Health's stock price declined more than twenty percent within the expiration period.[26] Later that same day IMS Health released its third-quarter earnings, which fell twenty-eight percent short of Wall Street's expectations.[27] IMS Health's stock dropped twenty-eight percent shortly after the market opened the next day, whereupon Dorozhko sold his put options, realizing a net profit of $286,456.59.[28]

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19. SEC v. Dorozhko, 574 F.3d 42, 49–50 (2d Cir. 2009).
20. *Id.* at 44.
21. *See* Complaint at 4, SEC v. Dorozhko, 606 F. Supp. 2d 321 (S.D.N.Y. 2008) (No. 07 Civ. 9606).
22. *Dorozhko*, 574 F.3d at 44. The events at issue occurred in October 2007. *Id.*
23. *Id.*
24. As the court explained, "[a] 'put' option is '[a]n option that conveys to its holder the right, but not the obligation, to sell a specific asset at a predetermined price until a certain date.... Investors purchase puts in order to take advantage of a decline in the price of the asset.' " *Id.* at 44 n.1 (second alteration in original) (quoting DAVID L. SCOTT, WALL STREET WORDS 295 (3d ed. 2003)).
25. *Id.* at 44.
26. *Id.*
27. *Id.*
28. *Id.*

The SEC sought a preliminary injunction freezing the proceeds from the put options of IMS Health stock under section 10(b), which prohibits the use of any deceptive device or contrivance in connection with the purchase or sale of a security.[29] To gain the injunction, the SEC had to make "a substantial showing of the likelihood of a violation of § 10(b)."[30] Analyzing the language of the statute, the district court isolated the term "deceptive" as the primary source of contention,[31] and undertook an exhaustive survey of insider trading jurisprudence to determine if a violation of section 10(b) required a breach of fiduciary duty.[32] The court ultimately concluded that deception as used in section 10(b) required the presence of—and subsequent breach of—a fiduciary duty.[33] Since the SEC could produce no evidence that Dorozhko breached any fiduciary duty, the district court denied the motion for a preliminary injunction.[34]

On appeal, the SEC maintained that Dorozhko's hacking was a fraudulent affirmative misrepresentation.[35] In contrast to the district court, the court of appeals began its analysis with the premise that the SEC's claim was separate from either of the two traditional insider trading theories[36]: the classical theory, wherein an " 'insider trades in the securities of his own corporation on the basis of material, non-public information,' "[37] and the misappropriation theory, which finds liability where " 'a person trades while in knowing possession of material, non-public information that has been gained in violation of a fiduciary duty to its source.' "[38] Free from the two traditional

29. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).

30. SEC v. Dorozhko, 606 F. Supp. 2d 321, 327 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42.

31. *Id.* at 329 ("Thus, for the SEC to prevail, we must find that the alleged scheme was 'deceptive' as that term is used in the statute.").

32. *Id.* at 331–43.

33. *Id.* at 338. The district court summarized its findings by asserting that "the Supreme Court has in a number of opinions carefully established that the essential component of a § 10(b) violation is a breach of a fiduciary duty to disclose or abstain that coincides with a securities transaction." *Id.*

34. *Id.* at 343.

35. Opening Brief of the SEC at 22–28, SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV).

36. *Dorozhko*, 574 F.3d at 45 ("[W]e recognize that the SEC's claim against defendant—a corporate outsider who owed no fiduciary duties to the source of the information—is not based on either of the two generally accepted theories of insider trading.").

37. *Id.* (quoting United States v. Cusimano, 123 F.3d 83, 87 (2d Cir. 1997)); *see also infra* Part II.C (discussing the traditional insider trading theories).

38. *Dorozhko*, 574 F.3d at 45 (quoting United States v. Cusimano, 123 F.3d 83, 87 (2d Cir. 1997)); *see also infra* Part II.C (discussing the traditional insider trading theories).

fiduciary-based theories,[39] the Second Circuit held that Dorozhko could be liable under this separate theory if his actions were "deceptive" within the ordinary meaning of section 10(b).[40] In framing the issue this way, the court acknowledged that it chose a different, more expansive definition of "deceptive" than did the Fifth Circuit, thereby creating a circuit split over the scope of section 10(b).[41]

II. FROM FRAUD TO SECURITIES FRAUD: THE SCOPE OF SECTION 10(B) AND RULE 10B-5

A. *Common Law Adoption*

The Second Circuit's holding that an actor need not be obligated by a fiduciary duty for an affirmative misrepresentation to fall under the "deceptive" language of section 10(b) finds support in common law principles of fraud.[42] This support represents a crucial foundation, as the Supreme Court has declared that section 10(b) is grounded in a common law understanding of fraud.[43] In his influential writing on concealment and common law fraud, Professor W. Page Keeton lays out the different types of possible fraud, separating out misrepresentations based on words or acts from failures to disclose

39. *Dorozhko*, 606 F. Supp. 2d at 331–36 (analyzing the precedent set by Supreme Court cases defining the classical and misappropriation theories).

40. *Dorozhko*, 574 F.3d at 45.

41. *Id.* at 48.

42. *Id.* at 51.

43. *See* Chiarella v. United States, 445 U.S. 222, 227–28 (1980) ("At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent."); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977). Although grounded in common law fraud, there is also indication that section 10(b) is meant to be more encompassing. *See, e.g.*, Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 173 (2008) (Stevens, J., dissenting) ("[O]ur prior cases explained that to the extent that 'the antifraud provisions of the securities laws are not coextensive with common law doctrines of fraud,' it is because common law fraud doctrines might be too restrictive." (quoting Herman & MacLean v. Huddleston, 459 U.S. 375, 388–89 (1983))); *In re* Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961) ("Section 10(b) [is a] ... broad remedial provision[] aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit."). *But see Stoneridge*, 552 U.S. at 162 (majority opinion) ("The argument that there could be a reliance finding if this were a common law fraud action is answered by the fact that § 10(b) does not incorporate common law fraud into federal law ...." (citing SEC v. Zandford, 535 U.S. 813, 820 (2002))). The Court, in announcing this proposition, relied on a principle of refusing to extend section 10(b) to "every common law fraud that happens to involve securities." SEC v. *Zandford*, 535 U.S. 813, 820. As a central tenet of fraud, the concept of affirmative misrepresentation does not fit this classification. *See In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) ("[T]he essence of fraud or deceit, at least at common law, is a misrepresentation that induces detrimental reliance.").

while under a duty of disclosure.[44] In fact, at common law the primary form of fraud was a misrepresentation made for the purpose of inducing reliance.[45] The extension of that principle led to the concept of fraud encompassing failure to disclose information when one is under a duty to do so.[46]

An analysis of the *Restatement of Torts* adopted during the period when section 10(b) was drafted is also particularly instructive. The *Restatement* first posits a theory of liability for fraudulent misrepresentations where "one ... fraudulently makes a misrepresentation of fact, opinion, intention or law" on which another relies.[47] The *Restatement* goes on to define "misrepresentation" as "not only words spoken or written but also any other conduct which amounts to an assertion not in accordance with the truth."[48] This "affirmative misrepresentation" theory of fraud is contrasted from a second, separate theory of liability derived from nondisclosure.[49] Under the "nondisclosure theory of fraud" a party is liable when she fails to "exercise reasonable care to disclose to the other ... such matters as the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between

44. W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 1–2 (1936) ("[I]t must be recognized that such conduct may consist of first, a misrepresentation by a direct statement, i.e., by the use of words; second, a misrepresentation resulting from the doing of certain acts; and finally, a misrepresentation by silence resulting from the failure to disclose the existence of something which the other person has reason to believe would be disclosed.").

45. GEORGE SPENCER BOWER, THE LAW OF ACTIONABLE MISREPRESENTATION 28 (1911) (" '[M]isrepresentation' has no concern with cases of non-disclosure, *as such*, that is, with cases of the *mere* violation of a duty, imposed by the policy of the law on parties standing in certain relations to one another, to observe the utmost good faith by ... disclosure of all known material facts ...."); Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1323 (2009) ("[T]he common law generally imposed liability for affirmative misstatements. Fraud by silence was actionable only in limited circumstances, and the default rule was one of caveat emptor."); Ronald F. Kidd, Note, *Insider Trading: The Misappropriation Theory Versus an "Access to Information" Perspective*, 18 DEL. J. CORP. L. 101, 107 (1993) ("Common law fraud normally required an affirmative misrepresentation in order to be actionable. Nondisclosure was grounds for fraud only in very limited circumstances.").

46. *See Chiarella*, 445 U.S. at 227–28 ("At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of the transaction commits fraud only when he is under a duty to do so."); Keeton, *supra* note 44, at 1–2 (discussing the inclusion of concealment as fraud when one is under a duty to disclose and the inherent problems therein).

47. RESTATEMENT OF TORTS § 525 (1938).

48. *Id.* § 525 cmt. b.

49. *Id.* § 551.

them."[50] Further, under the nondisclosure theory of fraud the actor is not liable for harm—even if she knows the other party is ignorant of material information—unless she is under a fiduciary duty to disclose.[51]

Thus, at the time section 10(b) was adopted, common law recognized two separate theories of liability for fraud: liability for affirmative misrepresentations and liability for nondisclosure when under a duty to disclose pertinent material information.

B. The Purpose of Section 10(b)

Set against this back-drop of common law fraud, the Securities Act of 1933[52] was promulgated to "provide investors with full disclosure of material information concerning public offerings of securities in commerce, *to protect investors against fraud* and ... to promote ethical standards of honesty and fair dealing."[53] The Act itself was necessary to restore confidence after the stock market crash of 1929.[54]

The Securities Exchange Act of 1934[55] furthered the twin goals of fairness and efficiency in the securities markets through section 10(b), 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 Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[56] The Securities Exchange Act of 1934 also created the Securities and Exchange Commission and provided it with a broad range of powers to create and enforce new regulations.[57] Rule 10b-5,[58]

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50. *Id.*

51. *Id.* § 551 cmt. a.

52. 15 U.S.C. §§ 77a–77aa (2006).

53. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976) (emphasis added) (citing H.R. REP. NO. 73-85, at 1–5 (1933)).

54. SEC v. Zandford, 535 U.S. 813, 819 (2002) (citing United States v. O'Hagan, 521 U.S. 642, 658 (1997)).

55. 15 U.S.C. §§ 78a–78nn (2006).

56. *Id.* § 78j (emphasis added).

57. *See, e.g.*, *id.* §§ 78i, 78s, 78u; *see also Ernst & Ernst*, 425 U.S. at 195 ("As part of the 1934 Act Congress created the Commission, which is provided with an arsenal of flexible enforcement powers.").

58. 17 C.F.R. § 240.10b-5 (2010). Under Rule 10b-5,

> [i]t shall be unlawful for any person, directly or indirectly ... (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material face necessary in order to make the statements made ... not misleading, or (c) [t]o engage in any act, practice, or

promulgated in 1942[59] and adopted in 1948,[60] has been the primary means through which the SEC has battled insider trading.[61]

Based on the language and the history of the statute, it is apparent that the overarching goal is to eliminate fraud from the securities market and promote fairness.[62] Similarly, there is nothing in the language to suggest that "deceptive" should be so narrowly construed as to apply only to cases where the actor owes a fiduciary duty, as the Fifth Circuit would interpret the term to require.[63] Indeed, the broadness of the Senate Report associated with section 10(b) supports a more liberal interpretation, declaring that the section was "aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function."[64] The Supreme Court itself has recognized the need for the statute to be construed expansively, stating that "Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed not technically and restrictively, but flexibly to effectuate its remedial purposes,"[65] and further recognizing that the statute was meant to serve as a "catchall provision."[66]

> course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

59. HAZEN, *supra* note 8, § 12.3[2], at 475–76.

60. Employment of Manipulative and Deceptive Devices by Any Purchaser of a Security, 13 Fed. Reg. 8,183 (Dec. 22, 1948).

61. Veronica M. Dougherty, *A [Dis]semblance of Privity: Criticizing the Contemporaneous Trader Requirement in Insider Trading*, 24 DEL. J. CORP. L. 83, 85 (1999); *see supra* note 18. As one district court has helpfully explained, "[t]he law of insider trading is not based on a federal statute expressly prohibiting the practice; it has instead developed through SEC and judicial interpretations of § 10(b)'s prohibition of 'deceptive' conduct and Rule 10b-5's antifraud provisions." SEC v. Cuban, 634 F. Supp. 2d 713, 720 (N.D. Tex 2009), *vacated*, 620 F.3d 551 (5th Cir. 2010).

62. Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 345 (2005) (stating that securities statutes maintain public confidence in the marketplace by deterring fraud); S. REP. NO. 104-98, at 4 (1995), *reprinted in* 1995 U.S.C.C.A.N. 679, 683.

63. Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 389 (5th Cir. 2007).

64. S. REP. NO. 73-792, at 6 (1934).

65. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)) (internal quotation marks omitted); *see also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (explaining that section 10(b) should be read "flexibly").

66. Chiarella v. United States, 445 U.S. 222, 234–35 (1980)). Speaking about what was to become section 10(b), *see* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201–03 (1976), drafter Thomas G. Corcoran said, "Of course [section 10(b)] is a catch-all clause to prevent manipulative devices[.] I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices." *Stock Exchange Regulation: Hearing on H.R. 7852 and H.R. 8720 Before the H. Comm. on*

A narrow reading of such an essential term of the statute as "deceptive," therefore, would serve only to frustrate the intent behind section 10(b). It would be contrary to the very essence of an antifraud statute designed to be construed both flexibly[67] and adaptively,[68] if an actor was able to affirmatively defraud the market and then escape liability simply because he lacked the requisite fiduciary duty. Numerous journal articles have explored the vexing conundrum of the computer hacker as a "mere thief" who can escape liability due to the absence of a fiduciary duty to disclose or abstain.[69] But an individual making an affirmative misrepresentation is distinguishable from the mere thief by the obvious and overriding presence of the misrepresentation as *a fraud itself*.[70] Misrepresentation, after all, inherently contains an element of fraud or deception, while theft can be achieved without trickery.[71]

Consequently, the language and intent of the legislation, combined with the principles of common law fraud present during its promulgation, encourage a reading that includes insider trading, affirmative misrepresentations as falling under the scope of section 10(b), and not limiting construction to only frauds where a fiduciary duty is present. A brief overview of Supreme Court insider trading jurisprudence and the incorporated reliance on fiduciary duty, however, serves to highlight the controversial nature of the *Dorozhko* decision.

Interstate and Foreign Commerce, 73d Cong. 115 (1934) (statement of Thomas G. Corcoran).

67. SEC v. Zandford, 535 U.S. 813, 819 (2002).

68. *Bankers Life*, 404 U.S. at 12 ("Since practices constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers in the regulatory agency have been found practically essential." (quoting H.R. REP. NO. 73-1383, at 6 (1934))) (internal quotation marks omitted).

69. *See, e.g.*, Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV. 181, 221–22 (2005–2006); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan *Suggestion*, 59 OHIO ST. L.J. 1223, 1253 (1998); Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 297–98 (1999) ("[T]hieves unrelated to the source of the information could steal the information without being in violation of existing federal securities laws."); Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 589–95 (2008) (discussing theft under section 10(b) and Rule 10b-5).

70. *See* discussion *infra* Part IV.B.

71. David Cowan Bayne, *Insider Trading: Ginsburg's* O'Hagan: *Insider Trading Ignored*, 53 U. MIAMI L. REV. 423, 470 (exploring the definitions of "theft" and "deceit").

C. Developing a Theory of Insider Trading Liability

The central premise driving securities regulation is parity of access to information, and the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."[72] So-called corporate insiders, meaning directors or management officers, are privy to information not generally known to the investing public, thereby creating a potentially problematic informational inequality.[73] Consequently, an insider in possession of material nonpublic information has a duty to "either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such information remains undisclosed."[74] The foregoing proposition is commonly referred to as the "disclose or abstain" rule[75] and serves as the basis for liability under the classical theory of insider trading. When the classical theory first reached the Supreme Court in *Chiarella v. United States*,[76] the Court adopted and applied the principle by holding that a financial printer who traded on material nonpublic information obtained from his employer did not violate section 10(b) by failing to disclose because he was under no fiduciary duty to disclose.[77]

The Court in *Chiarella* also entertained, but did not decide, the possibility that the defendant could be liable under section 10(b) for misappropriated information in breach of a fiduciary duty owed to his

72. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc); *see also* Symposium, *Insider Trading in Stocks*, 21 BUS. LAW. 1009, 1010 (1966) (explaining that market forces cannot operate where investors have no confidence in directors of public corporations or where corporate insiders seek to take advantage of inside information).

73. *Tex. Gulf*, 401 F.2d at 852 ("[I]nequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.").

74. *Id.* at 848; *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) ("[T]he courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.").

75. *See* Stanley Veliotis, *Rule 10b5-1 Trading Plans and Insiders' Incentive to Misrepresent*, 47 AM. BUS. L.J. 313, 319 (2010) (internal quotation marks omitted).

76. 445 U.S. 222 (1980).

77. *Id.* at 234–35. In *Chiarella*, an employee of a financial printer deduced confidential information concerning takeover bids that belonged to his employer. *Id.* at 224. He then traded on this information, realizing a profit of slightly more than $30,000 in the course of fourteen months. *Id.* The Court held that (1) defendant could not be liable under section 10(b) because he was under no duty to disclose since he was not an agent or fiduciary to the sellers, and (2) the section 10(b) duty to disclose does not arise from simply having possession of material nonpublic information. *Id.* at 234–35.

employer.[78] Following a circuit split on this "misappropriation theory,"[79] the issue again came before the Supreme Court—directly, this time—in *United States v. O'Hagan*.[80] James O'Hagan, a lawyer for a firm that represented a client poised to make an acquisition through tender offer, learned information from his employer and purchased call options in the stock of the company to be acquired before the tender offer was announced.[81] The Supreme Court decided that the misappropriation theory comported with section 10(b)'s "statutory requirement that there be 'deceptive' conduct 'in connection with' securities transactions"[82] and formally adopted the theory.[83] Although an evolution in the scope of liability for insider trading, the misappropriation theory was "premised on the same 'disclose or abstain' rationale as the traditional theory."[84]

Thus, both traditional theories of insider trading, classical and misappropriation, are based on the presence of fiduciary duty.[85] Viewed in that light, the controversy of the Second Circuit's decision in *Dorozhko* becomes clear. Yet as the Second Circuit correctly

78. *Id.* at 235–36. The Court did not decide the issue because it was not relevant on appeal. *Id.* at 236 ("We need not decide whether this theory has merit for it was not submitted to the jury.").

79. *Compare, e.g.*, United States v. Chestman, 947 F.2d 551, 566–67 (2d Cir. 1991) (en banc) (recognizing the Second Circuit's adoption of the misappropriation theory), *with* United States v. Bryan, 58 F.3d 933, 952 (4th Cir. 1995) (refusing to adopt the misappropriation theory).

80. 521 U.S. 642 (1997).

81. *Id.* at 647–48.

82. *Id.* at 658–59.

83. *Id.* at 666 ("The Eighth Circuit erred in holding that the misappropriation theory is inconsistent with § 10(b).").

84. SEC v. Dorozhko, 606 F. Supp. 2d 321, 334 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009).

85. *See* Liu Duan, Comment, *The Ongoing Battle Against Insider Trading: A Comparison of Chinese and U.S. Law and Comments on How China Should Improve Its Insider Trading Law Enforcement Regime*, 12 DUQ. BUS. L.J. 129, 135 (2009) (describing how the fiduciary-duty-based classical and misappropriation theories are "the current basis for U.S. insider trading regulations"). It is also worth noting that the Court has extended insider trading liability to reach non-insiders who owe no duty to the company, but to whom a corporate insider has passed material nonpublic information improperly. *See* Dirks v. SEC, 463 U.S. 646, 660 (1983). Under this theory, when a company insider (tipper) passes along material nonpublic information to an outsider (tippee) in violation of a fiduciary duty, the tippee assumes a fiduciary duty not to trade on the information. *Id.* at 660 ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider 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."); *see also* Carolyn Silane, *Electronic Data Theft: A Legal Loophole for Illegally-Obtained Information—A Comparative Analysis of U.S. and E.U. Insider Trading Law*, 5 SETON HALL CIRCUIT REV. 333, 343–44 (2009) (giving an overview of tipper-tippee liability).

notes, both of these theories rely on a nondisclosure theory of fraud.[86] And as apparent from common law fraud principles, nondisclosure is an entirely different species of fraud from the affirmative misrepresentation theory which served as the basis for liability in *Dorozhko*.[87]

III. A "DECEPTIVE" DISTINCTION: AFFIRMATIVE MISREPRESENTATION VERSUS FAILURE TO DISCLOSE

A. Dorozhko *Correctly Distinguished Between Cases Involving Affirmative Misrepresentation from Failure-to-Disclose Cases*

The distinction between an affirmative misrepresentation theory of fraud and a nondisclosure theory is especially important when examining the Supreme Court's insider trading jurisprudence because the entire relevant line of precedent represents an attempt by the Court to force insider trading into the category of failure to disclose—which, as discussed above, requires a fiduciary duty to be actionable.[88] For example, in *Chiarella* the Court struggled to apply liability in a situation where there was no affirmative misrepresentation, but rather the lawful possession and use of material information by an employee.[89] Faced with the absence of an affirmative misrepresentation, the Court drew from the alternate theory of fraud—an affirmative duty to disclose stemming from a fiduciary relationship.[90] The Court therefore held that because the petitioner was under no duty to abstain or disclose, he could not be held liable under section 10(b) *for his silence*.[91] Both *O'Hagan* and *SEC v. Zandford*[92] similarly lacked an affirmative misrepresentation, drawing

86. *Dorozhko*, 574 F.3d at 48 ("In *Chiarella*, *O'Hagan*, and *Zandford*, the theory of fraud was silence or nondisclosure, not an affirmative misrepresentation.").

87. *Id.* at 49 ("While *Chiarella*, *O'Hagan*, and *Zandford* all dealt with fraud *qua* silence, an affirmative misrepresentation is a distinct species of fraud.").

88. *See* Silane, *supra* note 85, at 341–47 (tracking the development of both the classical and misappropriation theories of insider trading liability).

89. Chiarella v. United States, 445 U.S. 222, 231–33 (1980).

90. *Id.* at 226–30 (setting forth that the legal issue at hand was whether silence violates section 10(b) and then adopting the *Cady, Roberts* rule that " 'insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons to whom they deal and which, if known, would affect their investment judgment' " (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961))).

91. *Id.* at 234.

92. 535 U.S. 813 (2002). *Zandford* involved a securities broker convicted of wire fraud for a scheme misappropriating his customer's funds. *Id.* at 815–16. The Court held that the requisite elements were met, such that liability under section 10(b) was proper. *Id.* at 825; *see infra* Part IV.B (discussing *Zandford*).

instead on a liability theory derived from a failure to disclose in breach of a fiduciary duty.[93]

Thus, although couched in disappointingly conclusory language, the rationale driving the Second Circuit's holding in *Dorozhko* was nonetheless correct.[94] Common law has given rise to two distinct methods of fraud: affirmative misrepresentations and silence while under an affirmative duty to disclose.[95] The major cases that shaped the Supreme Court's insider trading law stemmed from the nondisclosure prong, *not* the affirmative misrepresentation prong.[96] The Supreme Court has therefore established a fiduciary duty requirement only for failure-to-disclose cases, not for affirmative misrepresentations. The Second Circuit was thus correct in its summation of the Supreme Court's interpretation of section 10(b) as not requiring a fiduciary duty as an element for *all* fraudulent violations.[97]

B. *The Origin of the Rift: The Scope of Deception*

The Fifth Circuit, however, reached a different conclusion than the Second Circuit regarding the scope of section 10(b) in *Credit Suisse First Boston*. The split between the Second and Fifth Circuits arises from the proper way to define deception; specifically, whether the "deceptive" element of section 10(b) requires the presence—and subsequent breach—of a fiduciary duty.[98] In *Dorozhko*, the Second Circuit looked to the ordinary meaning of the term (as set forth in *Webster's New International Dictionary*), finding that "[i]n its ordinary meaning, 'deceptive' covers a wide spectrum of conduct involving cheating or trading in falsehoods."[99] The court found

93. *Zandford*, 535 U.S. at 820–21; United States v. O'Hagan, 521 U.S. 642, 654–55 (1997).

94. SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009).

95. *See supra* Part II.A.

96. *Dorozhko*, 574 F.3d at 48 ("In our view, none of the Supreme Court opinions relied upon by the District Court—much less the sum of the three opinions—establishes a fiduciary-duty requirement as an element of every violation of Section 10(b). In *Chiarella*, *O'Hagan*, and *Zandford*, the theory of fraud was silence or nondisclosure, not an affirmative misrepresentation."). Of course, both the Second Circuit in *Dorozhko* and the Fifth Circuit in *Credit Suisse First Boston* relied on *O'Hagan* and *Chiarella* in reaching their contrary conclusions regarding the role of fiduciary duty in the definition of deceptive. *See Dorozhko*, 574 F.3d at 48–50; Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 389 n.30 (5th Cir. 2007).

97. *See Dorozhko*, 574 F.3d at 48.

98. *See id.* ("At least one of our sister circuits has made the same observation relying on the same precedent.").

99. *Id.* at 50. For the specific definition used by the court, see WEBSTER'S NEW INTERNATIONAL DICTIONARY OF THE ENGLISH LANGUAGE 679 (2d ed. 1934)

dispositive an argument made in the SEC's brief that " '[d]eception,' based on the ordinary meaning of the term, includes any declaration, artifice or practice having the power to mislead, to cause to believe the false, or to disbelieve the true, as by falsification, concealment, or cheating; an attempt to lead into error; a trick or a fraud."[100] Indeed, according to the court, "[i]n its ordinary meaning, 'deceptive' covers a wide spectrum of conduct involving cheating or trading in falsehoods."[101] Based on this definition, the court held that the defendant could be liable for a violation of section 10(b) if he fraudulently obtained the material information used in the trade, even absent a fiduciary duty to the source.[102]

The Fifth Circuit took a different view in *Credit Suisse First Boston*, holding that the term "deceptive" in section 10(b) required a duty to disclose.[103] The court, in deciding whether to certify a class, reasoned that it was inappropriate to subscribe a common meaning to statutory text where the Supreme Court has "pointedly refused to define 'deceptive' in any way except through case law."[104] To do so, the court cautioned, is to "improperly ... substitute the authority of

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[hereinafter WEBSTER'S DICTIONARY]. The court relied on *Webster's Dictionary* based on *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 n.20 (1976), where the Court looked to that dictionary to define other key terms in section 10(b). The Supreme Court has looked to dictionaries contemporaneous with the promulgation of a statute to determine the ordinary meaning of terms in several other notable cases. *See* Amoco Prod. Co. v. S. Ute Indian Tribe, 526 U.S. 865, 874 (1999); Austin v. United States, 509 U.S. 602, 614 n.7 (1993).

100. *See* Opening Brief of the SEC, *supra* note 35, at 13.

101. *Dorozohko*, 574 F.3d at 50 (citing WEBSTER'S DICTIONARY, *supra* note 99, at 679).

102. *Id.* at 51.

103. 482 F.3d 372, 386 (5th Cir. 2007). The allegation in *Credit Suisse First Boston* was that the defendant banks formed partnerships and entered into transactions that allowed Enron Corporation to temporarily take liabilities off of its books and to falsely book revenue from transactions when it was actually incurring debt. *Id.* at 377. Essentially, these transactions allowed Enron to misstate its financial condition. *Id.* In order to determine whether the plaintiff class could be certified, the Fifth Circuit had to determine whether the district court's broad definition of "deceptive" (which included the banks' acts, even though no fiduciary duty was owed to the individual plaintiffs) was correct. *Id.* at 381–82.

104. *Id.* at 389. The court began with the premise that

> [d]ecisions interpreting the statutory text place a limit on the possible definitions that can be ascribed to the words contained in the SEC's rule promulgated thereunder. It is by losing sight of the limits that the statute places on the rule, and by ascribing, natural, dictionary definitions to the words of the rule, that the district court and like-minded courts have gone awry.

Id. at 387 (footnote omitted). Coincidently, the court cited to the exact same footnote in *Ernst & Ernst*, 425 U.S. at 199 n.20, when making this point as the court in *Dorozhko* did when supporting a completely contrary point. *See supra* note 99.

the dictionary for that of the Supreme Court."[105] The court surveyed relevant Supreme Court precedent—*Chiarella* and *O'Hagan*—and determined that there could be no violation of section 10(b) under the "deceptive" rubric absent a breach of a fiduciary duty to disclose.[106] The court further declared that it was improper to look to the common law meaning of "deceptive," since the Supreme Court had authoritatively passed on the language of the statute, thereby making the common law meaning of the language irrelevant.[107]

The source of contention between the circuits is thus whether the term "deceptive" as defined in the Supreme Court's leading insider trading cases requires a fiduciary duty, or if a deceptive affirmative misrepresentation, absent a fiduciary duty, is also sufficient for a violation.

C. *Defining Deception*

The Fifth Circuit arrived at its conclusion that deception must involve a breach of fiduciary duty by reasoning that, since the Supreme Court had interpreted the statute through case law, it consequently limited the possible definitions that could be attributed to specific words within section 10(b).[108] Therefore, the court reasoned, defining deception via the dictionary would be an improper substitution of authority.[109] The fallacy underlying the Fifth Circuit's conclusion, however, is the premise that the Supreme Court has authoritatively ruled that the term "deceptive" in section 10(b) always requires a breach of fiduciary duty.[110]

The Fifth Circuit cited to *Chiarella* and *O'Hagan* to support its proposition that the Court has established a fiduciary duty requirement for all deceptive acts under section 10(b).[111] Yet, as discussed above, *Chiarella* and *O'Hagan* stand only for the proposition that a fiduciary duty is required when the theory of liability is nondisclosure.[112] When the theory of liability arises from an

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105. *Credit Suisse First Bos.*, 482 F.3d at 389.

106. *Id.*

107. *Id.* ("[P]laintiffs' reference to the common law meaning of 'deceptive' is fruitless; where the Supreme Court has authoritatively construed the pertinent language of the statute . . . , the common law meaning of that language is irrelevant.").

108. *Id.*

109. *Id.* ("[D]efining 'deceptive' by referring to the same dictionary the Court used to define [another term in the statute] is improperly to substitute the authority of the dictionary for that of the Supreme Court.").

110. *See id.* at 389 n.30.

111. *Id.*

112. *See supra* Part III.A.

affirmative misrepresentation—as it did in *Dorozhko*—the Supreme Court has not foreclosed the possibility that liability may exist absent a fiduciary duty.[113] Consequently, since the Supreme Court has not authoritatively limited the meaning that can be ascribed to the term "deceptive" for all violations of section 10(b), using the dictionary to define the term as the Second Circuit did is not an impermissible substitution of authority.

The Second Circuit, therefore, did not engage in a great leap of inductive reasoning when it used the same dictionary the Supreme Court used in defining other relevant terms in section 10(b) to define "deceptive."[114] Yet the Fifth Circuit in *Credit Suisse First Boston* argued that the Supreme Court "has pointedly refused to define 'deceptive' in any way except through caselaw."[115] Perhaps a more reasonable interpretation is that the Supreme Court has not been presented with a situation necessitating an explicit definition of the term.[116] For example, at issue in *Ernst & Ernst v. Hochfelder*[117] was intent; the Court looked to the relevant terms that would further an understanding of a scienter requirement, to which a definition of "deceptive" would have been of no further clarifying assistance.[118] Omission of a definition for "deceptive" was thus not "pointed,"

113. *See supra* Part III.A.

114. SEC v. Dorozhko, 574 F.3d 42, 50 (2d Cir. 2009) ("In its ordinary meaning, 'deceptive' covers a wide spectrum of conduct involving cheating or trading in falsehoods." (citing WEBSTER'S DICTIONARY, *supra* note 99, at 679)).

115. 482 F.3d at 389.

116. The Supreme Court has used *Webster's Dictionary* to define terms in a similar securities context only twice; both occurrences related to a determination of the necessity of "scienter." *See* Aaron v. SEC, 446 U.S. 680, 696 n.13 (1980) (using the dictionary to define key terms in section 17 of the Securities Act of 1933 to determine if Congress intended a scienter requirement); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.21 (1976) (using the dictionary to define key terms in section 10(b) to determine if Congress intended a scienter requirement). It therefore appears that there are too few examples of the Court using a dictionary—in a similar context—to define securities-related statutory terms to support the Fifth Circuit's assertion that the Court has "pointedly refused" to define deception other than through case law. *See Credit Suisse First Bos.*, 482 F.3d at 389.

117. 425 U.S. 185 (1976). In *Ernst & Ernst*, the president and principal shareholder of a brokerage firm perpetrated a scheme to defraud customers of the firm. *Id.* at 189. Customers of the brokerage firm brought suit against the accounting firm, Ernst & Ernst, alleging that Ernst & Ernst aided and abetted the fraud by failing to conduct a proper audit. *Id.*

118. *Id.* at 198–99. The Court looked to the dictionary to define the terms "manipulative" and "device" to determine whether section 10(b) embraced negligent conduct. *Id.* at 199 nn.20–21. Since the definition of "device" included a deception requirement, and by corollary an intent requirement, to separately define "deceptive" would be supererogatory. *Id.* at 199 n.20 (quoting WEBSTER'S DICTIONARY, *supra* note 99, at 713 (defining "device" in part as "a scheme to deceive")).

meaning deliberate, as the Fifth Circuit asserted,[119] but rather simply not useful.

In fact, the Supreme Court has emphasized that the primary means of interpreting section 10(b) is through the language of the statute itself.[120] *Ernst & Ernst* is particularly representative of the Court's approach in this regard.[121] Confronted with the issue of whether section 10(b) required a showing of scienter, the Court began its analysis by performing a thorough examination of the language of the statute.[122] During its analysis the Court derived meaning from the dictionary's definition of "manipulative," "device," and "contrivance" to determine that a showing of intent was necessary.[123] The Court thereby signified that it is the common meaning of the words in the statute that should provide guidance in determining its scope.[124]

The Supreme Court further reinforced the importance of following the common meaning of the language of section 10(b) in *Santa Fe Industries, Inc. v. Green*.[125] In defining the boundaries of

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119. *Credit Suisse First Bos.*, 482 F.3d at 389.

120. *See Ernst & Ernst*, 425 U.S. at 197; *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring); *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 501 & n.150 (S.D.N.Y. 2005) (emphasizing that the Supreme Court begins any analysis of section 10(b) with the statute's text).

121. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 472 (1977) (relying on the manner in which the Court in *Ernst & Ernst* approached a section 10(b) statutory construction issue, beginning with the principle that intent must be derived from the language of the statute). In rejecting the SEC's argument that nothing in section 10(b) requires a "knowing or intentional practice[]," the Court stated, "the [SEC] would add a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Ernst & Ernst*, 425 U.S. at 198–99.

122. *Ernst & Ernst*, 425 U.S. at 198–99.

123. *Id.* at 199 nn.20–21. The Court refuted the argument that section 10(b) barred negligent conduct by looking to the common meaning of the words "manipulative," "device," and "contrivance" in the statute. *Id.* at 199. Finding the ordinary meaning of each of the terms indicative of intentional behavior, the Court declared that to accept the proposition that section 10(b) did not contain a scienter requirement for private action suits would be a deviation from the common meaning of those terms. *Id.*

124. *Id.* at 197. To determine the scope of section 10(b), the Court "turn[ed] first to the language of § 10(b) for 'the starting point in every case involving construction of a statute is the language itself.' " *Id.* (quoting *Blue Chips Stamps*, 421 U.S. at 756). The Court also noted that " 'legislation when not expressed in technical terms is addressed to the common run of men and is therefore to be understood according to the sense of the thing, as the ordinary man has a right to rely on ordinary words addressed to him.' " *Id.* at 199 n.19 (quoting Addison v. Holly Hill Fruit Prods., Inc., 322 U.S. 607, 617–18 (1944)).

125. 430 U.S. 462, 472–73 (1977). In *Santa Fe Industries*, minority stockholders brought suit against the majority shareholders, alleging a violation of section 10(b) because their shares had been fraudulently appraised in an attempt to freeze them out. *Id* at 467. The issue before the Court was whether there could be a violation of section 10(b) by a fiduciary absent a misrepresentation or failure to disclose. *Id.* at 470. The Court held that there could not. *Id.* at 476.

fraud, however, the issue before the Court was what constituted fraud when a fiduciary duty *was* present.[126] The Court rejected the petitioner's attempt to broaden the scope of fraud, finding that in all of the Court's prior cases there was some element of deception, and a cause of action under Rule 10b-5 was appropriate "only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute."[127] The Court, therefore, underscored the necessity that the act be deceptive in the ordinary meaning of the word[128] by clarifying that the presence of a fiduciary duty alone could not constitute grounds for section 10(b) liability.[129] As the Second Circuit has made clear, an affirmative misrepresentation, and specifically "misrepresenting one's identity in order to gain unauthorized access to information . . . , and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[130]

Further, *Credit Suisse First Boston* can also be distinguished based on the context in which the case arose. The issue facing the Fifth Circuit was certification in a securities class action suit.[131] Read narrowly, the court's holding that the "deceptive" language of section 10(b) requires a breach of a duty to disclose can be viewed only in light of establishing reliance in a private suit.[132] It is plausible that had the Fifth Circuit been presented with the facts of *Dorozhko*, they might have ruled largely in the same manner as the Second Circuit.[133]

126. *Id.* at 473–74. The minority shareholders argued that majority shareholders violated Rule 10b-5 by obtaining a fraudulent appraisal of the stock and then offering an amount greater than the appraised price " 'in order to lull the minority shareholders into erroneously believing that [Santa Fe was] generous.' " *Id.* at 467 (alteration in original) (quoting Appendix at 103a, *Santa Fe Indus.*, 430 U.S. 462 (No. 75-1753)).

127. *Id.* at 473–74.

128. *Id.* (citing *Ernst & Ernst*, 425 U.S. at 214, for the commonly understood definition of specific terms in section 10(b) for guidance on the scope of the statute).

129. *Id.*

130. SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

131. Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 379 (5th Cir. 2007).

132. *See id.* at 382–84. A broad interpretation of "deceptive acts" was necessary for a classwide presumption of reliance under a "fraud-on-the-market theory." *Id.* at 382. For a "fraud-on-the-market theory"—adopted by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)—to be applicable, the Fifth Circuit determined that there must be a duty flowing from the defendants such that the market had a right to rely on the defendant's actions. *Credit Suisse First Bos.*, 482 F.3d at 383.

133. Since reliance is not a requirement in an SEC suit, it is possible that the Fifth Circuit would have ruled largely the same as the Second Circuit if presented the *Dorozhko* case. *See* SEC v. Rana Research, Inc., 8 F.3d 1358, 1363–64 (9th Cir. 1993); SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985) (per curiam); SEC v. N. Am. Research & Dev. Corp., 424 F.2d 63, 84 (2d Cir. 1970). The problem with this argument is that the two Supreme Court

Even if so distinguished, however, carving out disparate definitions of the term "deceptive" dependent upon the context in which the act arises would serve only to further muddle an already perplexing insider trading jurisprudence.

IV. DEFENDING THE "STRAIGHTFORWARD" THEORY OF FRAUD

A. *The Second Circuit Could Have Relied on Additional Case Law*

Having correctly determined both that an affirmative misrepresentation was actionable under common law fraud[134] and that Supreme Court insider trading precedent arose from the distinct nondisclosure theory of fraud,[135] the Second Circuit could have gone even further in supporting the theory that an affirmative misrepresentation violates section 10(b) by relying on additional case law. The court cited only to *Basic, Inc. v. Levinson*[136] as support for an affirmative misrepresentation theory of liability.[137] The problem, however, is that *Basic* may not be the best foundation to *solely* ground an affirmative misrepresentation without further elaboration, as it dealt with the difference between abrogation of a duty to disclose and affirmative representations by corporate *insiders*.[138] This opens up the counterargument that insiders are always under an obligation not to mislead.[139]

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cases the Fifth Circuit relied on in asserting that "deceptive" contained a fiduciary requirement, *Chiarella* and *O'Hagan*, were not private civil litigations. *See* United States v. O'Hagan, 521 U.S. 642, 648 (1997) (noting that the government initiated the prosecution of the defendant); Chiarella v. United States, 445 U.S. 222, 224–25 (1979) (same). Accordingly, whether the case was brought by the SEC or by a private litigant should not be dispositive under the Fifth Circuit's reasoning.

134. *See supra* Part II.A.

135. *See supra* Parts II.C, III.A.

136. 485 U.S. 224 (1988).

137. SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009). The Second Circuit cited to footnote 18 in *Basic* for the proposition that a person is under an affirmative obligation not to mislead in business dealings. *Id.*

138. *See Basic*, 485 U.S. at 240 n.18.

139. *See id.* (distinguishing between insiders trading without disclosing from affirmative misrepresentations made by those under a duty not to mislead); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CALIF. L. REV. 1, 20 (1982) (explaining the duties insiders are under); Robert A. Prentice, *Scheme Liability: Does It Have a Future After* Stoneridge?, 2009 WIS. L. REV. 351, 406 ("[T]here is a strong common law and section 10(b) obligation not to defraud others, even if they are strangers."). Any counterargument attempting to distinguish cases finding section 10(b) liability absent a fiduciary duty based on the presence of a corporate insider because they are under an "ever-present duty not to mislead" appears to be misguided. *Basic*, 485 U.S. at 240 n.18; *see also* United States v. O'Hagan, 521 U.S. 642, 661 (1997) ("The Court did not hold in [Chiarella v. United States] that the *only* relationship promoting liability for trading on undisclosed information is the relationship between a corporation's insiders

An additional basis on which the Second Circuit could have grounded its reasoning is footnote 7 from *Superintendent of Insurance v. Banker's Life & Casualty Co.*[140] There, the Court cited to language from an earlier Second Circuit decision stating that section 10(b) and Rule 10b-5 " 'prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception.' "[141] The Court explicitly recognized that section 10(b) and Rule 10b-5 provide liability for the equivalent of common law fraud, and therefore, by corollary, both an affirmative misrepresentation and an abrogation of a duty to disclose are actionable thereunder.[142]

Bankers Life itself is an example of a case where the Court applied section 10(b) to a case involving simple fraud.[143] However, even though the decision was grounded in common law fraud, the Court still recognized the presence of a fiduciary duty.[144] In a private civil litigation context, other cases have explicitly held that liability for an affirmative misrepresentation requires no fiduciary duty.[145] In *Deutschman v. Beneficial Corp.*,[146] the Third Circuit held that the

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and shareholders."). As previously discussed, the difficulty in the insider trading jurisprudence has been attaching liability in the absence of an affirmative misrepresentation. *See* Chiarella v. United States, 445 U.S. 222, 227–28 (1980). Once there is no fiduciary duty, it is the presence of the fraud itself—the affirmative misrepresentation—that is dispositive. *Id.*

140. 404 U.S. 6, 11 n.7 (1971).

141. *Id.* (quoting A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967)).

142. *See* Steinbuch, *supra* note 69, at 573–74. For a discussion of fraud at common law, see *supra* Part II.A.

143. *Bankers Life*, 404 U.S. at 10. In *Bankers Life*, an insurance company's United States Treasury Bonds (an amount of almost $5,000,000) were sold through a fraud perpetrated by outside collaborators, a corporate officer, and a controlling shareholder. *Id.* at 7–8. As a result, the company lost those assets. *Id.* at 8–9. The Court held that section 10(b) provided available protection to the company. *Id.* at 13–14.

144. *Id.* at 12 ("The controlling stockholder owes the corporation a fiduciary obligation—one 'designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders.' " (quoting Pepper v. Litton, 308 U.S. 295, 307 (1939))).

145. *See, e.g.*, Deutschman v. Beneficial Corp., 841 F.2d 502, 506–07 (3d Cir. 1988); A.T. Brod & Co. v. Perlow, 375 F.2d 393, 396–97 (2d Cir. 1967); Fry v. UAL Corp., 895 F. Supp. 1018, 1032 (N.D. Ill. 1995) (recognizing option trader standing in affirmative misrepresentation context), *aff'd*, 84 F.3d 936 (7th Cir. 1996); Liebhard v. Square D Co., 811 F. Supp. 354, 355 (N.D. Ill. 1992) (same); *In re* Adobe Sys., Inc. Sec. Litig., 139 F.R.D. 150, 155 (N.D. Cal. 1991) (same); W. Alton Jones Found. v. Chevron U.S.A. Inc. (*In re* Gulf Oil/Cities Serv. Tender Offer Litig.), 725 F. Supp. 712, 744 (S.D.N.Y. 1989) (recognizing option trading standing in an affirmative misrepresentation action). *But see, e.g.*, Laventhall v. Gen. Dynamics Corp., 704 F.2d 407, 412–14 (8th Cir. 1983) (denying standing to plaintiff option trader under section 10(b) based on a lack of fiduciary duty); Starkman v. Warner Commc'ns, Inc., 671 F. Supp. 297, 306–07 (S.D.N.Y. 1987) (same).

146. 841 F.2d 502 (3d Cir. 1988).

defendants could be liable under section 10(b) despite the absence of a fiduciary duty.[147] The court explicitly stated that "[n]othing in [*Chiarella v. United States* or *Dirks v. SEC*] can be construed to require the existence of a fiduciary relation between a section 10(b) defendant and the victim of that defendant's affirmative misrepresentation."[148] Further, there have been several recent cases wherein the courts, applying a misappropriation theory of liability, have moved away from a basis in fiduciary relationships toward a more conduct-based approach.[149]

The breadth of case law, therefore, supports the Second Circuit's holding that an affirmative misrepresentation violates section 10(b) regardless of whether there is a breach of an underlying fiduciary duty. As long as the affirmative misrepresentation meets the ordinary meaning of "deceptive," the perpetrator of the act is liable for violating section 10(b) under a straightforward theory of fraud.[150] However, this conclusion has garnered its fair share of criticism, and several counterarguments to the Second Circuit's theory of fraud have been raised.

B. *Addressing Counterarguments: Why the Second Circuit's Approach is Preferable*

While an affirmative misrepresentation can violate section 10(b) if it is deceptive, even absent a fiduciary duty, there remains the

147. *Id.* at 508. The district court in this case relied on *Chiarella v. United States*, 445 U.S. 222 (1980), and *Dirks v. SEC*, 463 U.S. 646 (1983), in finding that the defendants could not be liable absent a special relationship of trust or confidence. Deutschman v. Beneficial Corp., 668 F. Supp. 358, 361–64 (D. Del. 1987), *rev'd*, 841 F.2d 502. The Third Circuit distinguished the case by explaining that "those cases dealt not with injury caused by affirmative misrepresentation . . . but with the analytically distinct problem of trading on undisclosed information." *Deutschman*, 841 F.2d at 506.

148. *Deutschman*, 841 F.2d at 506.

149. *See* SEC v. Rocklage, 470 F.3d 1, 13–14 (1st Cir. 2006) (holding that a wife violated section 10(b) by obtaining material nonpublic information from her husband and passing it along to her brother, despite the fact that she disclosed to her husband that she intended to share the information); SEC v. Cuban, 634 F. Supp. 2d 713, 725–26 (N.D. Tex 2009) (holding that a breach of a contractual agreement can serve as the basis for section 10(b) liability), *vacated*, 620 F.3d 551 (5th Cir. 2010). Additionally, the Supreme Court has indicated support for a conduct-based approach in a decision concerning section 10(b) in private action suits. *See* Stoneridge Inv. Partners, L.L.C. v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008) (rejecting the notion that section 10(b) liability must be predicated on misstatements, silence when under a duty to disclose, or manipulative practices and declaring that conduct can be deceptive). For a thorough and insightful discussion on the possibility of a deceptive acquisition theory of liability, see Nagy, *supra* note 45, at 1369–70.

150. *See* Hazen, *supra* note 9, at 901; *Caselaw Developments 2009—Overview*, 65 BUS. LAW. 923, 924 (2010).

argument that computer hacking, like other forms of theft, does not constitute a deceptive affirmative misrepresentation.[151] The precise question becomes, why is computer hacking actionable under section 10(b) while "mere theft" arguably is not?[152] The answer to this question lies in the very nature of the hacking at issue, and the degree to which it comports with both the ordinary meaning of deception and the principles of common law affirmative misrepresentation.[153]

The ordinary meaning of deception[154] and the *Restatement* definition of misrepresentation[155] are both in accord that an affirmative misrepresentation requires the assertion of a falsehood. Consequently, the means by which the hack is accomplished becomes dispositive. As Professor Orin Kerr explains in his article on cybercrime, there are two methods of gaining unauthorized access to a computer with user privileges regulated by code (i.e., password-protected): "engag[ing] in false identification and masquerad[ing] as another user" and "exploit[ing] a weakness in the code within a program to cause the program to malfunction in a way that grants the user greater privileges."[156]

If a hacker "engage[s] in false identification and masquerade[s] as another user,"[157] she would appear to be fulfilling the requirement of a false assertion under both the ordinary meaning of deception and the common law requirements for an affirmative misrepresentation

151. Brief on Behalf of Defendant-Appellee at 21–22, SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV) (arguing that computer hacking is not actionable under section 10(b)).

152. *See supra* note 69 and accompanying text.

153. *Dorozhko*, 574 F.3d at 50 ("[T]he District Court did not decide whether the ordinary meaning of 'deceptive' covers the computer hacking in this case—or, indeed, whether the computer hacking in this case involved any misrepresentation at all.").

154. WEBSTER'S DICTIONARY, *supra* note 99, at 679 (defining deceive as "[t]o cause to believe the false" and "[t]o impose upon; to deal treacherously with; cheat"); *see supra* text accompanying notes 99–102.

155. RESTATEMENT OF TORTS § 525 cmt. b (1938) (defining misrepresentation as "conduct which amounts to an assertion not in accordance with the truth").

156. Orin S. Kerr, *Cybercrime's Scope: Interpreting "Access" and "Authorization" in Computer Misuse Statutes*, 78 N.Y.U. L. REV. 1596, 1644–45 (2003) ("Circumventing regulation by code generally requires a user to engage in one of two types of computer misuse. First, the user may engage in false identification and masquerade as another user who has greater privileges. For example, the user can use another person's password, and trick the computer to grant the user greater privileges that are supposed to be reserved for the true account holder. . . . Alternatively, a user can exploit a weakness in the code within a program to cause the program to malfunction in a way that grants the user greater privileges."); *see also* BRUCE SCHNEIER, SECRETS AND LIES 135–41 (2000) (discussing computer access and prevalent methods of unauthorized access).

157. Kerr, *supra* note 156, at 1644.

theory of fraud.[158] To gain access, the hacker must falsely portray herself as someone else—either one with initial privilege to access or one with greater privileges than the hacker actually has. Professor Kerr recognizes the prospect of this false assertion as fraud, noting that false identification "resemble[s] fraud . . . because the computer does not recognize that it is consenting to access by that particular user."[159] He explains that this flows from the fact that "the computer is tricked into letting the user access the computer through a misrepresentation .... The computer may 'believe' that the user is someone else, as in the case of a defendant utilizing another person's username and password."[160] The hacker is literally tricking the computer, and in reliance on the hacker's false assertions the computer grants access, thereby coming under the purview of fraudulent affirmative misrepresentation.[161]

The Second Circuit distinguished the two different methods of gaining access—false identification and exploitation of a weakness in the code—by opining that false identification would clearly be a violation of section 10(b), whereas exploiting a code weakness would be more suitably categorized as mere theft, and therefore not actionable.[162] The presence of the false assertion, or trickery, is the crucial distinction between hacking that violates section 10(b) and mere theft; mere theft is not actionable because of the absence of fraud, or deception in the ordinary sense of the word.[163] Therefore,

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158. *See* RESTATEMENT OF TORTS § 525 cmt. b (1938); *supra* Part III.B.

159. Kerr, *supra* note 156, at 1655.

160. *Id.*

161. It may seem peculiar to use terms such as "believe" and "trick" when referring to an inanimate object such as a computer. Yet as the SEC pointed out in its brief, computers are largely being used to perform work historically carried out by humans, "such as granting and denying access to confidential information." Opening Brief of the SEC, *supra* note 35, at 24. Since "[t]he ultimate target of the deception is the company that owns the information," it is therefore "of no legal consequence" that the "deception is communicated through a computer system." *Id.* The U.S. Air Force Court of Military Review in *United States v. Flowerday*, 28 M.J. 705 (A.C.M.R. 1989), further clarified the issue by articulating an agency theory, declaring that it is the underlying legal entity "which is being deceived and which, in reliance on that deceit, is providing the service that forms the basis of the offense." *Id.* at 708; *see also* Thrifty-Tel, Inc. v. Bezenek, 54 Cal. Rptr. 2d 468, 474 (Cal. Ct. App. 1996) (finding a computer network to be an agent of the deceived party); Opening Brief of the SEC, *supra* note 35, at 24 n.9 ("Some courts have analyzed this issue in terms of the computer being the agent of the deceived party." (citing *Thrifty-Tel*, 54 Cal. Rptr. 2d at 474)).

162. SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

163. Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 122 (1984) ("When one simply steals information from a stranger, his trading on the information does not involve deception or fraud, and therefore should not be held to violate Rule 10b-5.").

the determination of whether computer hacking is actionable under section 10(b) will require an investigation by the court into whether the purported hacker utilized fraudulent means to gain access to the material nonpublic information.[164] The presence of deception should serve as the line of demarcation dividing actionable computer hacking from mere theft and—if properly analyzed—should prevent any undue expansion of insider trading liability into otherwise inactionable behavior.

Similarly, the existing framework under *SEC v. Zandford* will serve as a safeguard to guarantee that the hacking at issue satisfies the requisite degree of "connection with" the purchase and sale of a security,[165] thereby ensuring that insider trading liability is not unduly triggered for perpetrated frauds greatly attenuated from any securities transactions.[166] As the district court in *Dorozhko* concluded, "[t]he relevant test to determine whether a device is used in connection with securities transactions is whether the device and the transactions 'coincide.' "[167] Indeed, it is the "in connection with" requirement that prevents section 10(b) from acting as "a broad federal remedy for all fraud."[168]

Under the *Zandford* framework, the hack must coincide with the purchase or sale of securities, meaning it must be part of a single scheme.[169] In *Zandford*, the defendant, a securities broker, sold his customers' securities and then used the proceeds for his own

164. *See Dorozhko*, 574 F.3d at 51 (remanding for a determination "whether the computer hacking . . . involved a fraudulent misrepresentation that was 'deceptive' within the ordinary meaning of Section 10(b)"); Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of* United States v. O'Hagan, 8 FORDHAM J. CORP. & FIN. L. 865, 894–95 (2003) (discussing the competing perspectives of whether hacking is more analogous to deceptive impersonation or theft).

165. SEC v. Zandford, 535 U.S. 813, 819 (2002) ("Section 10(b) of the Securities Exchange Act makes 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 [SEC] may prescribe.") (alterations in original) (emphasis added) (quoting 15 U.S.C. § 78j (2006)).

166. *See* Nagy, *supra* note 69, at 1255 (discussing the difficulty in meeting the "in connection with" requirement for affirmative deceptions based on computer hacking).

167. SEC v. Dorozhko, 606 F. Supp. 2d 321, 328–29 (S.D.N.Y. 2008) (citing *Zandford*, 535 U.S. at 822), *vacated*, 574 F.3d 42.

168. Marine Bank v. Weaver, 455 U.S. 551, 556 (1982) (citing Great W. Bank & Trust v. Kotz, 532 F.2d 1252, 1253 (9th Cir. 1976); Bellah v. First Nat'l Bank, 495 F.2d 1109, 1114 (5th Cir. 1974)); *see also* SEC v. Zandford, 238 F.3d 559, 566 (4th Cir. 2001) ("[W]e decline to stretch the language of the securities fraud provisions to encompass every conversion or theft that happens to involve securities."), *rev'd*, 535 U.S. 813.

169. *Zandford*, 535 U.S. at 824–25.

benefit.[170] The Supreme Court found the "in connection with" requirement met because the defendant intended from the beginning of the scheme to keep the proceeds from the sales, the scheme being complete when the sale of securities took place.[171] A computer hack will be actionable, therefore, if it is part of a single scheme that becomes complete upon the purchase or sale of securities.[172] In analyzing *Dorozhko*, the district court found persuasive the proximity in time between the hack and securities transactions (thirty-five minutes), and the relative lack of value of the information "apart from its use in a securities transaction" in finding the "in connection with" requirement met.[173] Ensuring that the hack and the securities transaction "coincide" by analyzing the proximity of the two events, the nature of the scheme, and the relative intrinsic value of the information will serve to prevent section 10(b) from expanding beyond its role as a federal remedy for fraud "in connection with" securities transactions.

Yet even with the above confining safeguards, the *Dorozhko* decision has already drawn criticism from scholars arguing that it stretches the current insider trading rubric too far to encompass activity that traditionally was not considered actionable under section 10(b).[174] Others have worried that the court's straightforward theory of fraud represents a "slippery slope" that could potentially lead to the inclusion of all thefts under section 10(b).[175] The concern driving these counterarguments is that an overly broad section 10(b) will lead to uncertainty in the marketplace[176] and will be used as an amorphous general liability statute to govern thefts only tangentially related to corporate securities trading.[177]

170. *Id.* at 815.

171. *Id.* at 824–25.

172. *See Dorozhko*, 606 F. Supp. 2d at 328–29.

173. *Id.* at 329.

174. *See, e.g.*, Stephen M. Bainbridge, *The Second Circuit's Egregious Decision in* SEC v. Dorozhko, PROFESSORBAINBRIDGE.COM (July 29, 2009, 4:36 AM), http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html ("So much for treading cautiously. After *Dorozhko*, 10b-5 will take over the corporate universe.").

175. *See, e.g.*, Amy Greer, *Guest Column: "Straightforward Theory of Fraud" Leads Second Circuit onto Slippery Slope*, SEC. DOCKET, (July 30, 2009, 6:00 AM), http://www.securitiesdocket.com/2009/07/30/guest-column-straightforward-theory-of-fraud-leads-second-circuit-onto-slippery-slope/.

176. *See* Bainbridge, *supra* note 174; Greer, *supra* note 175.

177. Bainbridge, *supra* note 174.

These arguments, however, overlook the safeguards already in place to prevent over-inclusiveness in section 10(b) jurisprudence: the "in connection with" and "deceptive" requirements. Further, these arguments miss the simplistic strength of the Second Circuit's standard. In bypassing the lattice of legal theory that was necessary to support the commonly accepted methods of insider trading theory, courts are now able to focus on the essential core of the issue: the presence of actual deception. Nor is there a realistic danger of all thefts becoming actionable under section 10(b); the Second Circuit made clear that the relevant inquiry is whether the defendant's actions constitute a fraudulent misrepresentation within the common meaning of deception.[178] Consequently—even if it does meet the "in connection with" requirement—a simple theft absent any behavior qualifying as fraudulent or deceptive will not be subject to section 10(b) liability.[179]

V. FUTURE IMPLICATIONS

Through its decision that fraudulent affirmative misrepresentations represent a valid cause of action under section 10(b), the Second Circuit has given the SEC a powerful weapon with which to pursue violators.[180] The standard for liability is now simply the ordinary meaning of "deceptive," which, as the court proclaimed, "covers a wide spectrum of conduct involving cheating or trading in falsehoods."[181] The inherent broadness of this standard is facially apparent. As discussed above, the Second Circuit differentiated between the two primary standards of computer hacking—misrepresenting one's identity to gain access to information versus exploiting a weakness in the programming code to gain access—and found that misrepresentation of one's identity would be deceptive under section 10(b).[182]

Under this precedent, the relevant inquiry in determining if a violation of section 10(b) has occurred will be whether the case involves "a fraudulent misrepresentation that [is] 'deceptive' within

178. SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

179. *Id.*

180. *Id.*

181. *Id.* at 50 (citing WEBSTER'S DICTIONARY, *supra* note 99, at 679).

182. *Id.* at 51 ("In our view, misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the meaning of the word. It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft.").

the ordinary meaning of Section 10(b)."[183] It appears that the SEC is therefore free from any obligation to fit the purported perpetration into either of the currently available doctrines of insider trading[184] and can now truly focus on the presence of the fraud itself. This standard will undoubtedly alter both the types of cases the SEC will pursue and the manner in which the SEC proceeds with those cases.

The power of the *Dorozhko* approach stems from the fact that it is not tethered to either the classical or misappropriation theories of insider trading.[185] As the Second Circuit stated, "an affirmative misrepresentation is a distinct species of fraud."[186] Further, the court categorized its newly adopted standard as a "straightforward theory of fraud."[187] Put into context, this means that the SEC can now pursue cases of insider trading without needing to show either: (a) the defendant remained silent while under a duty to disclose;[188] or (b) the defendant misappropriated material nonpublic information from a source to whom he owed a duty.[189] The primary focus for the SEC is now the presence of fraud and deception.

Examples from a few notable recent cases where the SEC settled serve to illustrate how the SEC can implement the new standard to target individuals who trade on fraudulently obtained nonpublic information. In *SEC v. Lohmus Haavel & Viisemann*,[190] the SEC brought suit against three individuals, alleging that they fraudulently misrepresented themselves as a client to Business Wire, Inc. to obtain material nonpublic information[191] and trade on the information.[192]

183. *Id.*

184. *See supra* Part I (discussing the misappropriation and classical theories).

185. *Dorozhko*, 574 F.3d at 45 ("[W]e recognize that the SEC's claim against defendant—a corporate outsider who owed no fiduciary duties to the source of the information—is not based on either of the two generally accepted theories of insider trading.").

186. *Id.* at 49.

187. *Id.*

188. *See supra* Part I (explaining that the classical theory requires a defendant to fail to disclose information when under a duty to disclose).

189. *See supra* Part I (explaining that the misappropriation theory is based on the defendant's duty to a person from who he misappropriated the information).

190. No. 05 CV 9259 (S.D.N.Y. May 30, 2007).

191. Complaint at 2–3, SEC v. Lohmus Haavel & Viisemann, No. 05 CV 9259 (S.D.N.Y. May 30, 2007), *available at* http://www.sec.gov/litigation/complaints/comp19450.pdf. Business Wire, Inc. operated a secure website in order to allow its clients to submit news releases to be disseminated to the public. *Id.* at 2. The defendants misrepresented themselves as a client to Business Wire in order to gain client access and then launched a "spider" computer program which retrieved confidential new releases before they were released to the public. *Id.* The defendants settled, disgorging the profits and paying a civil penalty of $650,000. Litigation Release, SEC, Court Issues Final

With the standard set forth in *Dorozhko*, the SEC would be able to focus solely on proving that the defendants' actions fell under the broad, ordinary meaning of "deceptive" rather than being forced to settle because of the difficulties in proving that the individuals had fiduciary duties. Perhaps pushing the theory even further is the case of *SEC v. Stummer*.[193] There, the defendant snuck into his brother-in-law's bedroom office and gained access to confidential information which he later traded on by correctly guessing his brother-in-law's password on the office computer.[194] Under the Second Circuit's standard, the SEC could establish liability by proving that the defendant affirmatively misrepresented himself as his brother-in-law to obtain the material nonpublic information, thereby meeting section 10(b)'s deception requirement.

CONCLUSION

By holding that fiduciary duty is not a required element for all violations of section 10(b), the Second Circuit has streamlined the cause of action for the SEC, while at the same time remaining true to the original spirit of the statute. Section 10(b) was meant to be construed flexibly to achieve its antifraud purpose[195] and to serve as a " 'catchall' provision"[196]—two propositions seemingly at odds with any holding that would attempt to narrow the interpretation of the text from its ordinary meaning. Furthermore, the Second Circuit's holding is both solidly grounded in a common law understanding of fraud and supported by case law from both the Supreme Court and lesser courts. But most importantly of all, the Second Circuit has effectuated the goal of section 10(b) by giving the SEC free reign to focus on the presence of fraud in the cases it pursues, regardless of the presence of fiduciary duty. The result of the SEC's operation under the Second Circuit's standard will likely be the pursuit of more fraudulent activities, including those thought perhaps unreachable before the Second Circuit clarified the fiduciary requirement—with

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Judgment by Consent Against Defendants Oliver Peek and Lohmus Haavel & Viisemann (May 31, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20134.htm.

192. Complaint, *supra* note 191, at 4–12.

193. No. 08 CV 3671 (S.D.N.Y. Apr. 23, 2008).

194. Complaint at 3–6, SEC v. Stummer, No. 08 CV 3671 (S.D.N.Y. Apr. 23, 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp20529.pdf.

195. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (citing SEC v. Capital Gains Research Bureau, 375 U.S. 180, 186 (1963)); *see also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) ("Section 10(b) must be read flexibly, not technically and restrictively.").

196. Chiarella v. United States, 445 U.S. 222, 246 (1980) (Blackmun, J., dissenting).

the corresponding logical consequence that more fraudulent marketplace behavior will be punished. The Second Circuit's decision in *Dorozhko*, therefore, achieves section 10(b)'s fundamental purpose by allowing it to freely be what it was drafted to be: an *antifraud* statute.

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