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WE'RE STILL AGAINST FRAUD, AREN'T WE? *UNITED STATES v. O'HAGAN*: TRIMMING THE OAK IN THE WRONG SEASON

INTRODUCTION

The Securities and Exchange Commission ("SEC" or "Commission") and government prosecutors¹ have utilized Rule 10b-5 as a primary weapon against insider trading.² This method of enforcement began when Securities and Exchange Commissioner Sumner Pike indicated approval of the rule by

¹ For purposes of this Comment, SEC enforcement and government prosecutorial actions will be referred to collectively as "government" actions. In this connection, see *infra* notes 59-64 and accompanying text (positing that distinctions between private actions and governmental actions are crucial in properly construing Supreme Court pronouncements concerning Rule 10b-5).

² 17 C.F.R. § 240.10b-5 (1996). Rule 10b-5 was promulgated by the Securities and Exchange Commission ("SEC" or "Commission") pursuant to its authority under section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act"), which provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange....

(b) To use or employ, in connection with the purchase or sale of any 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.

15 U.S.C. § 78j (1994). In 1942, the SEC exercised its rule-making authority under section 10(b) when it promulgated Rule 10b-5, which provides that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

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

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

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

17 C.F.R. § 240.10b-5 (1996).

asking, "Well, we are against fraud aren't we?"³ Although section 10(b) of the Securities and Exchange Act of 1934 ("Exchange Act")⁴ was not initially designed to be used in such capacity,⁵ the section's broad language has allowed the government to utilize it to combat trading by corporate insiders.⁶ Indeed, Chief Justice Rehnquist noted the undefined and expansive powers of Rule 10b-5 when analogizing the Rule to "a judicial oak which has grown from little more than a legislative acorn."⁷

The government has brought cases under two theories of Rule 10b-5 liability, colloquially referred to as the "classical theory"⁸ and the "misappropriation theory."⁹ The misappropriation

³ Milton Freeman, one of Rule 10b-5's original drafters, observed that when he brought the rule before the commissioners, "[they] read the rule and ... 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?'" *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) [hereinafter *Conference on Codification*].

⁴ 15 U.S.C. § 78j (1994).

⁵ See *Sante Fe Indus., Inc. v. Green*, 430 U.S. 462, 473 n.13 (1977) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 202 (1976)) ("Neither the intended scope of § 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the legislative history"); RALPH C. FERRARA & HERBERT THOMAS, *FERRARA ON INSIDER TRADING & THE WALL* § 1.02 (noting that "[t]he only provision of the securities statutes that expressly regulates insider trading is Section 16 of the Exchange Act ... Present-day liability for insider trading stems primarily from Section 10(b) ... and SEC Rule 10b-5 [which] do not formally define (or even mention) insider trading."); see also Marc Mellett, Comment, *Is There Life After Bryan?: The Validity of Rule 10b-5's Misappropriation Theory*, 34 DUQ. L. REV. 1057, 1059-60 (1996). Rule 10b-5 was invoked to prosecute insider trading by buyers of securities since the SEC had limited the use of the Rule's anti-fraud counterpart, section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a) (1994), to the prosecution of only sellers of securities. Mellett, *supra*, at 1059-60; see also Timothy J. Horman, Comment, *In Defense of United States v. Bryan: Why the Misappropriation Theory is Indefensible*, 64 FORDHAM L. REV. 2455, 2458 (1996) (noting while section 10(b) is currently government's primary weapon against insider trading, legislative history of Exchange Act indicates Congress originally intended for section 16 to combat insider trading).

⁶ The term "corporate insiders" includes officers, directors, controlling shareholders, and those who receive inside information from corporate insiders and tippees. See R. CLARK, *CORPORATE LAW* 264 (1986).

⁷ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975). Then Justice Rehnquist wrote these oft quoted words discussing the extent to which Rule 10b-5 countenanced private civil actions. *Id.*

⁸ See *Dirks v. SEC*, 463 U.S. 646, 657-60 (1983) (discussing obligation of tippee to disclose or abstain from trading on nonpublic information from insiders); *Chiarella v. United States*, 445 U.S. 222, 227-30 (1980) (discussing duty of corporate shareholders and insiders to disclose confidential material information). The *Chiarella* court refined the elements of the classical theory used against true insiders of the corporation. Under this refinement, individuals violate Rule 10b-5 when they

theory was first introduced by the government in *Chiarella v. United States*,¹⁰ where the Supreme Court ultimately declined to address its validity because the issue had not been submitted to the jury.¹¹ Five members of the *Chiarella* court, however, did indicate varying levels of support for the theory.¹² Thereafter, several circuit courts have expressed approval of the misappropriation theory.¹³ Recently, however, the theory has been

buy or sell securities on the basis of material non-public information if (i) they owe a fiduciary or similar duty to the other party to the transaction; (ii) they owe a fiduciary duty to the shareholders of the company in whose shares they are trading by virtue of their position as an insider of the corporation; or (iii) they are tippees who received information from such an insider and know or should know that the insider breached a fiduciary duty in giving the information. *Dirks*, 463 U.S. at 657-60; *Chiarella*, 445 U.S. at 227-30.

⁹ See, e.g., *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990). The court in *Clark* laid out the elements of the misappropriation theory, which incorporates within the reach of Rule 10b-5 those who are not traditional "corporate insiders," and are therefore outside the reach of the classical theory. The court stated:

Rule 10b-5 is violated [under the misappropriation theory] when a person (1) misappropriates material non-public information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock.

Id.

¹⁰ 445 U.S. 222 (1980).

¹¹ *Id.* at 236.

¹² See *id.* at 237-52 (concurring and dissenting opinions). In his concurrence, Justice Stevens suggested that in determining whether the defendant is criminally liable under Rule 10b-5 for breaching his duty of silence owed to his employer, "a legitimate argument could be made that [the defendant's] actions constituted 'a fraud or a deceit' upon those companies 'in connection with the purchase or sale of any security.'" *Id.* at 238. Chief Justice Burger and Justice Brennan indicated that anyone who misappropriates material non-public information has a duty to either disclose the information or abstain from trading altogether. See *id.* at 239-40. Justices Blackmun and Marshall argued that a violation of Rule 10b-5 arises not only when there is a relationship of trust, but may also exist under special facts of misrepresentation. *Id.* at 247-48.

¹³ Three circuit courts have expressly endorsed the misappropriation theory. See *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992) (stating that Rule 10b-5 is violated by misappropriation of material information); *Clark*, 915 F.2d at 449 (citing legislative, administrative, and judicial history of Rule 10b-5 and section 10(b) as support for misappropriation theory); *United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981) (imposing Rule 10b-5 liability based on deceitful misappropriation of confidential information), *aff'd after remand*, 722 F.2d 729 (2d Cir.), *cert. denied*, 464 U.S. 863 (1983). Circuits endorsing the misappropriation theory contend that the Third Circuit has likewise adopted the theory in *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (3d Cir. 1986), *cert. denied*, 481 U.S. 1017 (1987). See *Cherif*, 933 F.2d at 410 (citing *Rothberg* as adoption of misappropriation theory by Third Circuit). *But see United States v. Bryan*, 58 F.3d 933, 943 n.5 (4th Cir. 1995) (contending that *Rothberg* court did not expressly or impliedly adopt theory). The Supreme Court has yet

strongly contested at the federal appellate level.¹⁴ In *United States v. O'Hagan*,¹⁵ the United States Court of Appeals for the Eighth Circuit became the second circuit court to reject this fixture of the government's Rule 10b-5 prosecutorial arsenal.¹⁶ Consequently, the Supreme Court granted the government's petition for certiorari in the *O'Hagan* case, and is expected to render a decision on this split among the circuits in early summer 1997.¹⁷

In *O'Hagan*, the defendant was a partner in the Minneapolis law firm of Dorsey & Whitney.¹⁸ In July 1988, a large London-based company, Grand Met PLC, retained the Dorsey & Whitney firm to act as local counsel in a potential acquisition of the Minneapolis-based Pillsbury Company.¹⁹ In August 1988, armed with knowledge that the acquisition of Pillsbury was likely, O'Hagan began purchasing Pillsbury securities.²⁰ By October 4, 1988, when Grand Met PLC publicly announced its tender offer for Pillsbury, O'Hagan had accumulated substantial positions in Pillsbury securities.²¹ After the announcement, the price of Pillsbury stock rose from \$39 per share to nearly \$60 per share.²²

to rule on the validity of the misappropriation theory. In *Chiarella v. United States*, 445 U.S. 222 (1980), the Court refused to consider the issue, and in *Carpenter v. United States*, 484 U.S. 19 (1987), the Court divided evenly (4 to 4) on the validity of a conviction based on the misappropriation theory, affirming the Second Circuit's decision while failing to provide any discussion.

¹⁴ See, e.g., *Bryan*, 58 F.3d 933 (4th Cir. 1995). The *Bryan* court categorically rejected the misappropriation theory, holding that (i) the language of section 10(b) and Rule 10b-5, (ii) the legislative purposes of section 10(b), and (iii) the Supreme Court's interpretive precedent of Rule 10b-5 provide no support for the theory. *Id.* at 944.

¹⁵ 92 F.3d 612 (8th Cir. 1996), cert. granted, 117 S. Ct. 759 (1997) (No. 96-842).

¹⁶ *Id.* at 622.

¹⁷ See *O'Hagan*, 117 S. Ct. 759 (1997) (No. 96-842); see also *FDA Deposition Rebuff; SEC Appeals*, NAT'L L. J., Dec. 16, 1996, at A10 (noting that SEC asked Supreme Court to grant certiorari); Dominic Bencivenga, *Legitimate Enforcement? Misappropriation Theory before High Court*, 217 N.Y. L.J. 5 (1997) (indicating Court will likely hear case in April).

¹⁸ *Id.* at 614

¹⁹ *Id.*

²⁰ *Id.*

²¹ *O'Hagan*, 92 F.3d at 614. O'Hagan purchased both Pillsbury common stock and call options for Pillsbury stock. *Id.* Call options are contracts giving the holder the right to purchase a designated number of shares at a designated price. *Id.* at 614 n.1. By the end of September 1988, O'Hagan acquired 2,500 call options, and 5,000 shares of Pillsbury common stock. *Id.*

²² *Id.* at 614; see also *SEC v. Maio*, 51 F.3d 623, 628 n.3 (7th Cir. 1995) ("When a tender offer is [publicly] announced, usually the price of the target company rises and the price of the offeror falls or remains the same.").

O'Hagan thereafter liquidated his entire position in Pillsbury securities, reaping over \$4,000,000 in profits.²³ The government subsequently brought fifty-seven charges against O'Hagan, which included mail fraud, violations of federal money laundering statutes, and violations of federal securities laws.²⁴ A trial ensued and a jury found O'Hagan guilty on all fifty-seven counts.²⁵ On appeal, O'Hagan argued that the misappropriation theory, on which the government relied to convict him of securities fraud, was impermissible as a matter of law.²⁶ The Eighth Circuit agreed and noted that because his convictions for mail fraud and money laundering were predicated on the securities law violations,²⁷ they were forced to reverse and remand the case to the district court for dismissal of the entire indictment.²⁸

Writing for the majority, Judge Hansen concluded that neither the statutory language of section 10(b)²⁹ nor the Supreme Court precedent interpreting that section³⁰ supported the use of the misappropriation theory. In holding that the misappropriation theory failed to meet the "deception" and "in connection

²³ *O'Hagan*, 92 F.3d at 614.

²⁴ *Id.* "Counts 1-20 charged [O'Hagan] with mail fraud ... [c]ounts 21-37 charged him with securities fraud in violation of § 10(b) and Rule 10b-5 Counts 38-54 charged O'Hagan with securities fraud in violation of § 14(e) and Rule 14e-3 ... promulgated thereunder. Counts 55-57 alleged various violations of the federal money laundering statutes, 18 U.S.C. §§ 1956(a)(1)(B)(i) and 1957." *Id.* The court noted that O'Hagan raised "a whole host of issues" on appeal, but stated that it would address only the claims relating to the securities fraud violations. *Id.* at 613-14. Although the court did provide substantial discussion regarding O'Hagan's section 14(e) claim, the scope of this comment is limited to a discussion of the court's treatment of Rule 10b-5.

²⁵ *SEC v. O'Hagan*, 901 F. Supp. 1461 (D. Minn. 1995), *rev'd*, 92 F.3d 612 (8th Cir. 1996).

²⁶ *O'Hagan*, 92 F.3d at 615.

²⁷ *Id.* at 622, 627. The court noted that the indictment was structured in a manner that premised the mail fraud and money laundering charges "on the acts allegedly constituting the securities fraud." *Id.* at 627. When the court decided that O'Hagan's acts did not constitute securities fraud, it found that there was no fraud upon which to base the other charges. *Id.* at 628.

²⁸ *Id.*

²⁹ *O'Hagan*, 92 F.3d at 615-16, 618 (noting that text of section 10(b) is controlling and concluding that it cannot support misappropriation theory); *see also* *Chiarella v. United States*, 445 U.S. 222 (1980) (noting that section 10(b) that is "aptly described as a catchall provision, but what it catches must be fraud").

³⁰ *O'Hagan*, 92 F.3d at 617-18 (explaining that Supreme Court precedent effectively precludes misappropriation theory based on strict interpretation of section 10(b)).

with" requirements of section 10(b),³¹ Judge Hansen pulled language from a patchwork of Supreme Court precedent, which warned against overbroad constructions of section 10(b).³² Similarly, Judge Hansen criticized those courts which have adopted the misappropriation theory for failing to rigorously examine applicable precedent³³ and for advancing a seemingly facile "assumed unfairness" rationale.³⁴

This Comment examines the *O'Hagan* decision, suggesting that it is an unduly strict interpretation of section 10(b) and an overly inclusive synopsis of the scope of Supreme Court securities law decisions. Original Congressional intent and recent Congressional action justify the misappropriation theory's place within section 10(b)'s scope. The *O'Hagan* court's highly lexical

³¹ See *supra* note 2 (providing text of section 10(b) of Exchange Act).

³² *O'Hagan*, 92 F.3d at 617-20. To support the assertion that the misappropriation theory fails to meet the "deception" requirement of section 10(b), Judge Hansen relied upon *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (refusing to ascribe more expansive meaning to Rule 10b-5 than section 10(b) permits and stating only "material misstatement[s]" and "manipulative act[s]" are proscribed by section 10(b)); *Santa Fe Indus. v. Green, Inc.*, 430 U.S. 462, 476 (1977) (noting section 10(b) does not encompass mere breaches of fiduciary duty absent misrepresentation or nondisclosure); and *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (stating determination of fiduciary duty is based on whether insider will personally benefit from nondisclosure).

Judge Hansen further concluded that the misappropriation theory is violative of section 10(b) requirements because it imposes liability for breaches of duty owed to persons outside contemplated securities transactions. *O'Hagan*, 92 F.3d at 618. Judge Hansen explained that this extension violates the clear mandate of section 10(b) that the fraud be "in connection with the purchase or sale of any security." *Id.* Additionally, the concept of a "duty" is critical to the analysis of insider trading. The aim of the classical theory was to prevent an insider of the corporation from using information for his own advantage at the expense of the shareholders to whom a fiduciary duty was owed. *Id.* The impetus in providing the misappropriation theory was a need to similarly deter "outsiders" from using such information. *Id.*

To explain his conclusion, Judge Hansen cited *Chiarella*, 445 U.S. at 230 (stating that duty to disclose arises only between parties to transaction); *Dirks*, 463 U.S. at 657-58 (stating that duty arises because of relationship between parties to transaction and not merely because of one party's position in market); and *Central Bank*, 511 U.S. at 180 (noting violations of 10(b) occur when purchaser or seller relies on manipulative device or misstatement).

³³ In this connection, Judge Hansen cited *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), as a case that the *O'Hagan* court "borrowed heavily from" and one that yielded analysis which the *O'Hagan* court "adopt[ed] ... entirely as [its] own." *O'Hagan*, 92 F.3d at 620.

³⁴ See *id.* at 621 (rejecting imposition of Rule 10b-5 liability on grounds that it is fundamentally unfair to allow individuals to trade on basis of information that is unavailable to other traders) (citing *United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986), *aff'd in part and rev'd in part*, 484 U.S. 19 (1987)).

analysis of section 10(b) and Supreme Court decisions regarding the misappropriation theory are unfortunately timed. In an era of increased insider trading investigation, the *O'Hagan* court's strict interpretation of section 10(b) severely constricts the government's ability to protect the integrity of the securities markets. An adoption of the *O'Hagan* reasoning by the Supreme Court would force the government to seek legislative reform to enlarge the scope of section 10(b). The current conservative nature of Congress would likely present an insurmountable obstacle to such reform resulting in very limited prosecutorial powers for the government to combat insider trading.

Part One of this Comment examines the *O'Hagan* court's holding that the misappropriation theory is inconsistent with the "deception" and "in connection with" requirements of section 10(b). Part Two analyzes the intent of Congress in enacting section 10(b) and subsequent insider trading regulations, and discusses the likely effects of a Supreme Court adoption of the *O'Hagan* analysis on the government's insider trading enforcement program.

I. DEFINING DECEPTION IN CONNECTION WITH THE PURCHASE OR SALE OF SECURITIES

A. Section 10(b)'s "Deception" and Rule 10b-5's "Fraud" Requirements

In 1942, the SEC promulgated Rule 10b-5,³⁵ in which the word "fraud" was used to outline the range of conduct proscribed by the word "deception" in section 10(b).³⁶ Courts initially limited the application of Rule 10b-5 to situations involving nondisclosures where a common law fiduciary duty existed between parties to a business deal.³⁷ This requirement of a duty was inter-

³⁵ See *Conference on Codification*, *supra* note 3 (noting circumstances surrounding Milton Freeman's drafting of Rule 10b-5 in 1942); see also *supra* note 2 (providing text of Rule 10b-5).

³⁶ See *supra* note 2 (providing text of Rule 10b-5 and section 10(b) of Exchange Act).

³⁷ See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 946 (1952) (noting Congress' intent was solely to protect shareholders of corporations against breaches of fiduciary duty by corporate insiders); *Kardon v. Nat'l Gypsum Co.*, 73 F. Supp. 798, 803 (E.D. Pa. 1947) (stating provisions of section 10(b) apply to officers and directors of corporations who buy stock from others who have no knowledge of facts known to officers and directors because of their posi-

jected because at common law a buyer or seller had no obligation to disclose material facts absent a duty to do so.³⁸ The original effect of this duty was to limit the scope of Rule 10b-5 liability to traditional corporate insiders.³⁹

Governmental attempts to broaden the scope of Rule 10b-5 liability to include those individuals who were not traditional corporate insiders were initially successful,⁴⁰ but subsequently curtailed in *Chiarella v. United States*.⁴¹ In *Chiarella*, a financial

tions).

³⁸ See *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (citing Restatement (Second) of Torts § 551(2)(a) (1976)). This duty arises when one party in a fiduciary relationship possesses information which the other is entitled to know as a result of the trust and confidence embodied in such a relationship. *Id.*

³⁹ See *Kardon*, 73 F. Supp. at 800; Mellett, *supra* note 5, at 1060 (discussing effect of judicial requirements placed upon early Rule 10b-5 actions); see also Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 74 (1984) (discussing earlier court confinement of fiduciary duty relationship between corporate insiders and minority shareholders and noting difficulty of applying same duty to "outside tippees" with confidential information).

⁴⁰ In *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), the SEC attempted to assert the broad "any person" language of Rule 10b-5 to extend liability to anyone who had access to material nonpublic information by virtue of an association with a corporation. *Id.* at 911. The Court explicitly extended the duty to disclose to all those who enjoy a "relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose." *Id.* at 912. The SEC asserted that Rule 10b-5 is designed to address "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." *Id.* The argument that Rule 10b-5 was designed to assure equal access to all investors was initially adopted by the Second Circuit in *SEC v. Texas Gulf Sulfur Co.*, 401 F.2d 833, 851-52 (2d Cir. 1968) (en banc), *cert. denied*, 404 U.S. 1005 (1971). In *Texas Gulf Sulphur*, the Second Circuit reinstated a criminal suit against a geologist who was employed by a corporation to conduct exploratory drilling for mineral deposits, and traded in the corporation's securities based on material nonpublic information that indicated valuable mineral deposits had been found. *Id.* at 977. The court, deferring to Rule 10b-5's broad scope, found the geologist to be an "insider" based on his access to the information. *Id.* at 976. Over time, courts have been willing to enlarge the category of persons deemed to owe a fiduciary duty to shareholders. See Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 107-08 (1984). Later, in *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980), the Second Circuit further expanded the scope of Rule 10b-5, holding that anyone who possesses inside information assumes a duty to either disclose or abstain from trading. *Id.* at 1364. *But see infra* notes 43-44 (noting Supreme Court reversal of general 'disclose or abstain' duty of *Chiarella*).

⁴¹ 445 U.S. 222, 235 (1980) (holding mere possession of nonpublic information does not impose duty to disclose or abstain from trading). Again, the Supreme Court emphasized that Rule 10b-5 cannot be read "more broadly than its language and the statutory scheme reasonably permits." *Id.* at 234 (quoting *SEC v. Sloan*, 436 U.S. 103, 116 (1978)).

printer purchased stock in target companies without informing its shareholders of the knowledge he gained while handling transaction documents regarding proposed takeovers.⁴² The Supreme Court rejected the argument that the failure to disclose such knowledge, absent a duty to do so, was violative of Rule 10b-5.⁴³ Moreover, the Court held that a section 10(b) duty to disclose does not arise from mere possession of nonpublic market information.⁴⁴

In a well crafted dissent, Chief Justice Burger originated the misappropriation theory,⁴⁵ positing that, even absent a fiduciary duty, a person can violate Rule 10b-5 by misappropriating inside information and later trading upon it.⁴⁶ Such misappropriation, according to Chief Justice Burger, imposes upon the misappropriator a duty to either disclose or abstain from trading.⁴⁷ Therefore, any subsequent trade would constitute a breach of that duty and a violation of Rule 10b-5.⁴⁸

The government seized upon Chief Justice Burger's misappropriation theory and began to forward it as a basis for Rule

⁴² *Id.* The printer, Chiarella, gained access to the names of target companies just prior to public announcements of mergers and acquisitions. *Id.* at 224. Chiarella purchased securities of the target company before the deal was publicly announced, and sold them for profit immediately after the announcement. *Id.*; see *supra* note 22 (explaining that target company's stock price generally rises pursuant to such public announcements).

⁴³ *Chiarella*, 445 U.S. at 235 ("When an allegation of fraud is based upon non-disclosure, there can be no fraud absent a duty to speak.")

⁴⁴ "We cannot affirm petitioner's conviction without recognizing a general duty between all [market participants] ... to forgo actions based on material, nonpublic information ... [such a recognition] should not be undertaken absent some explicit evidence of congressional intent." *Id.* at 233.

⁴⁵ "[T]he evidence shows beyond all doubt that Chiarella ... misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates § 10(b) and Rule 10b-5." *Id.* at 245 (Burger, C.J., dissenting).

⁴⁶ *Chiarella*, 445 U.S. at 240. Chief Justice Burger noted the common law rule that a party to an arms-length business transaction has no duty to disclose information to the other "unless the parties stand in some confidential or fiduciary relation." *Id.* Chief Justice Burger further argued that the common law rule should "give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means." *Id.* He then concluded that section 10(b) and Rule 10b-5 encompass the idea "that a person who has misappropriated nonpublic information has an absolute duty" to disclose or abstain from trading. *Id.*

⁴⁷ *Id.* at 240.

⁴⁸ See *supra* notes 45-46 (explaining Chief Justice Burger's theory).

10b-5 liability on the trial level.⁴⁹ Within ten years, three federal circuit courts expressly adopted the theory.⁵⁰ These courts have held that the requisite fraud needed for Rule 10b-5 liability is present in the misappropriation of confidential information.⁵¹ Proponents of the theory believe that:

[b]y becoming part of a fiduciary or similar relationship, an individual is implicitly stating that she will not divulge or use to her own advantage information entrusted to her in the utmost confidence. She deceives the other party by playing the role of the trustworthy employee or agent; she defrauds it by actually using the stolen information to its detriment.⁵²

B. *The O'Hagan Court's Analysis of section 10(b)'s "Deception" Requirement*

It is submitted that the *O'Hagan* court used a narrow reading of section 10(b) and a strained analysis of Supreme Court precedent to conclude that the misappropriation theory does not mandate "deception."⁵³ Indicating that it was undertaking a very textual analysis,⁵⁴ the court heavily relied upon *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,⁵⁵ in which the Supreme Court narrowly construed Rule 10b-5.⁵⁶ Similarly,

⁴⁹ See, e.g., *United States v. Newman*, 664 F.2d 12, 16 (2d Cir.) (arguing for imposition of Rule 10b-5 liability on "outsider" based on misappropriation theory), *aff'd after remand*, 722 F.2d 729 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

⁵⁰ See *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991) (expressly adopting misappropriation theory), *cert. denied*, 502 U.S. 1071 (1992); *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990); *Newman*, 664 F.2d 12; see also *Rothberg v. Rosenbloom*, 771 F.2d 818, 823 (3d Cir. 1985) (arguably adopting misappropriation theory), *rev'd after remand*, 808 F.2d 252 (3d Cir. 1986), *cert. denied*, 481 U.S. 1017 (1987).

⁵¹ See, e.g., *Newman*, 664 F.2d at 17 ("[W]e need spend little time on the issue of fraud and deceit [T]he defendant 'misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence.'") (quoting *Chiarella v. United States*, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting)).

⁵² *Clark*, 915 F.2d at 448.

⁵³ "[C]ontrary to § 10(b)'s explicit requirements, the misappropriation theory does not require 'deception,' and, even assuming that it does, it renders nugatory the requirement that the 'deception' be 'in connection with the purchase or sale of any security.'" *United States v. O'Hagan*, 92 F.3d 612, 617 (8th Cir. 1996).

⁵⁴ The *O'Hagan* court suggested that the Supreme Court has "repeatedly held" that Rule 10b-5 has inelastic bounds. *Id.* But see *infra* notes 59-65 and accompanying text (arguing *O'Hagan* court's reliance on Supreme Court pronouncements was misplaced).

⁵⁵ 511 U.S. 164 (1994).

⁵⁶ *Id.* at 179 (concluding § 10(b) does not contemplate aiding and abetting liability).

the court cited *Santa Fe Industries v. Green*,⁵⁷ to justify its conclusion that the misappropriation theory is invalid because it permits the imposition of Rule 10b-5 liability "without misrepresentation or nondisclosure."⁵⁸ Rather than conducting an independent review of section 10(b)'s language, the *O'Hagan* court relied exclusively upon the aforementioned Supreme Court interpretations of Rule 10b-5's reach under section 10(b) which are distinguishable from the case at bar.⁵⁹

The *O'Hagan* court mistakenly relied upon the Supreme Court's decision in *Central Bank*, which only contemplated the scope of private causes of action under section 10(b).⁶⁰ Similarly, reliance on *Santa Fe* was misguided because the Supreme Court only addressed the availability of a private cause of action for minority shareholders based on the alleged negligent conduct of majority shareholders.⁶¹ Public policy considerations in governmental enforcement actions differ widely from those present in the Supreme Court cases relied upon by *O'Hagan*.⁶² It is not con-

⁵⁷ 430 U.S. 462, 479 (1977) (holding in private action under Rule 10b-5 mere instances of corporate mismanagement in which essence of complaint is that shareholders were treated unfairly by fiduciary are not violative of section 10(b) or Rule 10b-5).

⁵⁸ *O'Hagan*, 92 F.3d at 618.

⁵⁹ *Id.* at 617-18. The Court never independently dissected the statutory language in section 10(b). Indeed, the Court itself suggested that it disapproved of the misappropriation theory simply "[a]fter carefully studying the *Supreme Court's* teachings on the scope of conduct reachable under § 10(b) ... coupled with the recent *Central Bank* ruling." *Id.* at 617 (emphasis added).

⁶⁰ See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180 (1994). Analysis of *Central Bank* indicates that the *O'Hagan* court was grappling with the "scope of conduct prohibited under § 10(b)" within the confines of "determining the elements of the 10b-5 private liability scheme." *Id.* at 173 (emphasis added). The Court noted that the idea of private liability under 10b-5 was judicially created and previous cases regarding private suits had emphasized rigid adherence to statutory language. *Id.*

⁶¹ See *Santa Fe Indus. v. Green*, 430 U.S. 462, 464-65 (1977). The *Santa Fe* court pointed out that "not all breaches of a fiduciary duty in connection with a securities transaction come within the ambit of Rule 10b-5." *Id.* at 472. This statement, however, finds no discord in the misappropriation theory. In fact, it has been noted that a fiduciary's breach of the duty of care or of loyalty, if accompanied by full disclosure, would not amount to deception or fraud actionable under the misappropriation theory. See Recent Cases, *Securities Law—Insider Trading—Fourth Circuit Rejects Misappropriation Theory of Rule 10b-5 Fraud Liability*, 109 HARV. L. REV. 524, 536 (1995) [hereinafter Recent Cases]. Notably, the very facts presented in *Santa Fe*, an allegedly unfairly structured merger accompanied by full disclosure, "would not constitute misappropriation for § 10(b) purposes." *Id.* at 539 n.25.

⁶² See *infra* notes 65 (comparing public policy discussed in Supreme Court decisions to public policy considerations in government enforcement actions). Indeed,

tended that the misappropriation theory is mandated by the language of section 10(b) or Rule 10b-5, but rather that the broad wording of those sections in light of the SEC's congressional mandate permits such interpretation. Consequently, the judiciary is left to delineate the scope of section 10(b) by way of policy considerations.⁶³

The *O'Hagan* court's reliance on Supreme Court policy analysis wholly distinguishable from criminal cases such as *O'Hagan*⁶⁴ was an abdication of its own duty to accord proper

directly after the *Central Bank* court indicated the text of the act was controlling, it repeated a concern for limiting the private liability scheme by stating, "our cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory language." *Central Bank*, 511 U.S. at 173 (emphasis added). The Supreme Court's hesitance in creating and thereafter expanding private rights of action is well established. See *Touche Ross & Co. v. Redington*, 442 U.S. 560, 571 (1979) ("[I]mplying a private right of action on the basis of congressional silence is a hazardous enterprise, at best."); *Santa Clara Pueblo v. Martinez*, 436 U.S. 49, 64 (1978) (stating that courts must be unusually hesitant to infer private rights of action from congressional silence).

⁶³ See Recent Cases, *supra* note 61, at 538 ("[G]iven the broad wording and scant legislative history of section 10(b) ... courts appear to have a large and inescapable role in making their own policy judgments regarding the scope and aims of the statute and rule."); see also *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) ("It is therefore proper that we consider ... [in Rule 10b-5 cases] what may be described as policy considerations when we come to flesh out the portions of the law with respect to which neither the congressional enactment nor the administrative regulations offer conclusive guidance.").

⁶⁴ Most of the cases cited in *O'Hagan* turn on policy considerations unrelated to criminal prosecutions, such as cases involving private causes of action under Rule 10b-5, including (i) the potential for vexatious litigation "different in degree and in kind from that which accompanies litigation in general," *Blue Chip Stamps*, 421 U.S. at 739, (ii) the potential for significant interference with normal market activity resulting from "nuisance" suits (also known as "strike" or "blackmail" suits), *id.* at 740-41, and (iii) the "potential for possible abuse of the liberal discovery provisions of the Federal Rules of Civil Procedure," *id.* at 741. It is clear that the Supreme Court is reticent in these private Rule 10b-5 cases to permit judicial access to "plaintiff[s] with ... largely groundless claim[s]." *Id.*; see also *Central Bank*, 511 U.S. at 180 (refusing extension of aiding and abetting liability to private actions citing policy reasons in light of Congressional intent); *Santa Fe*, 430 U.S. at 479 (concurring with *Blue Chip Stamps*' concern regarding vexatious litigation). Conversely, the Supreme Court has recognized the government's role in carrying out the broad aims of the statutory scheme in section 10(b). See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199-200 (1976) (noting section 10(b) was "catchall" section of remedial legislation which should be construed flexibly); see also *United States v. Bryan*, 58 F.3d 933, 946-47 (4th Cir. 1995) (conceding principal concern of section 10(b) is protection of purchasers and sellers of securities). Indeed, the text of section 10(b) expressly provides the policy analysis that should be undertaken in granting the SEC power to create rules that the agency deems to be "in the public interest." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).

weight to policy considerations,⁶⁵ as well as a clear rejection of the deference traditionally accorded to administrative agencies empowered by broad congressional mandate.⁶⁶ In sum, it is submitted that the deceitful activity required by the misappropriation theory fits comfortably within the scope of section 10(b), and that the Supreme Court cases relied upon by the *O'Hagan* court do not necessitate a different understanding.

C. *The Nexus: Section 10(b)'s "In Connection With" Requirement*

The *O'Hagan* court held that the misappropriation theory failed "on another, more obvious basis."⁶⁷ Section 10(b) requires that the deception involved be "in connection with the purchase or sale"⁶⁸ of securities. Citing certain Supreme Court decisions as dispositive,⁶⁹ the *O'Hagan* court held that the misappropriation

⁶⁵ See Recent Cases, *supra* note 61, at 538 (noting court's policy making role in construing section 10(b) because of broad language used by Congress). Congress cannot, of course, delegate its general role as policy maker to administrative agencies, but may delegate specific policy making tasks to such agencies either expressly or implicitly. See *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-45 (1984) (discussing policy making role of agencies in relation to Congressional intent and action). Therefore, to the extent that Congress, through section 10(b), gave the SEC power to "prescribe [rules] ... in the public interest," judicial deference in reviewing the SEC's own interpretations of Rule 10b-5 should be at its apogee. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994); see also Recent Cases, *supra* note 61, at 541 (arguing that misappropriation "theory does serve broader, public interest functions....").

⁶⁶ See *supra* note 64 (noting intent of Congress to grant SEC broad rule making authority); see also Nat Stern, *The Constitutionalization of Rule 10b-5*, 27 RUTGERS L.J. 1 (1995) (discussing Supreme Court's application of constitutional law doctrine and ignorance of traditional methods of statutory interpretation). Most of Professor Stern's thoughtful exposition on the Supreme Court's recent restrictive views of section 10(b) is beyond the scope of this Comment. Professor Stern asserts, however, that the Supreme Court's formal stance is to recognize "a generous latitude for reasonable agency interpretation[s]" of statutes where the statutory language does not clearly resolve the issue at hand. *Id.* at 24 (citing generally *P.U.D. No.1 v. Washington Dep't of Ecology*, 571 U.S. 700, 711-13 (1994); *Reiter v. Cooper*, 507 U.S. 258, 269 (1993)). With regard to section 10(b), the Supreme Court recognized that the language could not resolve the issue, and that it was not able to "divine ... the intent of Congress." *Blue Chip Stamps*, 421 U.S. at 737. The *O'Hagan* court refused to even feign recognition of the Supreme Court's formal doctrine by dismissing the reasonable interpretation of section 10(b) made by the SEC, as well as the application of this theory by sister circuits which have adopted the misappropriation theory.

⁶⁷ *O'Hagan*, 92 F.3d at 618 (noting court "need not tarry long" on issue of deception because misappropriation theory fails "in connection with" requirement).

⁶⁸ Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994); see also *supra* note 2 (providing text of section 10(b)).

⁶⁹ See *O'Hagan*, 92 F.3d at 618 (analyzing Supreme Court decisions in *Chiarella*, *Dirks*, and *Central Bank* with regard to section 10(b)'s "in connection with" lan-

tion theory failed to meet the "in connection with" requirement of section 10(b) because the theory "permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in ... securities transaction[s]."⁷⁰

The *O'Hagan* court extrapolated too much from the Supreme Court cases it relied upon and ignored Supreme Court precedent tending to indicate that the "in connection with" requirement is not actually an onerous one. For example, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,⁷¹ the Supreme Court stated that the fraud must merely "touch" the purchase or sale of any security.⁷² Additionally, the *O'Hagan* court heavily relied upon *United States v. Bryan*,⁷³ which expressly recognized that the Supreme Court has not restricted the scope of section 10(b) to reach only purchasers or sellers.⁷⁴ Further, it has been widely recognized that trading involving the misappropriation of inside information can seriously damage market integrity and cause injury to investors and market stability as a whole.⁷⁵ It is doubt-

guage). The court posited that the Supreme Court pronouncements in the *Chiarella*, *Dirks*, and *Central Bank* cases applied to the *O'Hagan* case and weighed the government's arguments "[a]gainst this venerable body of law." *Id.* at 619. The court then concluded that after careful scrutiny of the Supreme Court's analysis in those cases, "the misappropriation theory ... cannot be defended." *Id.* at 619.

⁷⁰ *Id.* at 618. Noting that the Supreme Court explained the principal concern of section 10(b) is the "protection of purchasers and sellers of securities," *id.* (quoting *United States v. Bryan*, 58 F.3d 933, 946-47 (4th Cir. 1995)), the *O'Hagan* court decided that the misappropriation theory failed to meet the requirements of section 10(b) because it could potentially impose liability upon a class of persons outside the realm of traditional purchasers or sellers. *O'Hagan*, 92 F.3d at 619. In short, it is troubling to critics of the misappropriation theory that liability could be liberally expanded beyond the parties to the transaction to "an infinite number of trust relationships." *Id.*

⁷¹ 404 U.S. 6 (1971).

⁷² *Id.* at 12-13 (stating section 10(b) is violated when injury is suffered "as a result of deceptive practices touching" securities transactions).

⁷³ 58 F.3d 933 (4th Cir. 1995).

⁷⁴ See *id.* at 948 (noting Court has not expressly limited scope of statute to purchasers and sellers, but has loosely defined outer limits as reaching no further than fraud upon investors); William R. McLucas & Alma M. Angotti, *Insider Trading: Is It Back or Did It Ever Go Away?*, *INSIGHTS*, vol. 9, no. 10, 8 (October 1995) (noting that Supreme Court has not set up restrictive "in connection with" standard *Bryan* court implemented).

⁷⁵ McLucas & Angotti, *supra* note 74, at 8. Trading by misappropriators is likely to drive up "the price of the company's securities, making the bidder's acquisition more expensive." *Id.* at 11 n.83. Additionally, the rise in purchase price may induce other investors holding securities of that company to sell quickly, at a lower price than could be realized on a sale after the public dissemination of the information stolen by the misappropriator. *Id.* at 11 n.84. There is also general injury to the public in such trades by misappropriators of information "to the extent that the honesty

ful that corporations attempting to acquire other companies, when faced with higher acquisition costs resulting from a misappropriator's trades, would agree that the corporation had no "connection" to the purchase of securities by the misappropriator.⁷⁶ It is submitted that the *O'Hagan* court followed an unduly restrictive reading of section 10(b) because the Supreme Court did not propound an exhaustive list of possible parties meeting the "in connection with" test, and because the "touch" test enunciated by the Supreme Court should be read in conjunction with Congress' broad attempt to proscribe practices that "fulfill no useful function"⁷⁷ in the securities markets.⁷⁸

II. LIKELY EFFECTS OF AN ADOPTION OF THE O'HAGAN ANALYSIS

The Exchange Act was passed in response to the 1929 market crash, which Congress determined was fueled largely by the inside trading of market participants.⁷⁹ In passing the Exchange

and integrity of the markets are impaired." *Id.* It is the preservation of market integrity otherwise injured by manipulative trading that members of the Supreme Court have noted "lies close to the heart of what the securities laws are intended to prohibit." *Chiarella v. United States*, 445 U.S. 222, 246 (1980) (Blackmun, J., dissenting).

⁷⁶ See *McLucas & Agnotti*, *supra* note 74, at 11 n.83 (noting acquiring company will incur higher acquisition expenses because of misappropriator's trades). Additionally, *O'Hagan* was purchasing 30-day stock options, and was thus prompted to continually seek new inside information for determining whether to purchase new options after older ones had expired. See *supra* note 21 (explaining call option contracts). Thus, "the connection between the information acquisition and the purchase decision ... seems closer than in most cases." John C. Coffee Jr., "In *O'Hagan*, the Supreme Court gets second chance to adopt, and define the scope of, SEC's 'misappropriation theory' of insider trading," NAT'L L.J., Feb. 17, 1997, at B5.

⁷⁷ See *SEC v. Clark*, 915 F.2d 439, 450 (9th Cir. 1990) (quoting S. REP. NO. 73-792, at 6 (1934)). The phrase "no useful function" has been called upon by courts to support a broad reading of section 10(b). See *id.* (citing *United States v. Carpenter*, 791 F.2d 1024, 1030 (2d Cir. 1986), *aff'd in part and rev'd in part*, 484 U.S. 19 (1987); *SEC v. Peters*, 735 F. Supp. 1505, 1519 (D. Kan. 1990)).

⁷⁸ The *O'Hagan* court's recognition of the constitutional confines of Rule 10b-5, namely that Rule 10b-5 can be read no more broadly than section 10(b) permits, may have precluded the court's application of more traditional methods of statutory examination. See *Stern*, *supra* note 66, at 3 ("By transplanting a constitutional approach to this setting, the Court has slighted the usual doctrine and philosophy of statutory construction."). A preferable approach would be to adopt a more traditional analysis of agency interpretation of congressional statutes, involving judicial deference to reasonable agency interpretations, and substantive examinations of congressional intent. See *supra* notes 64-65 and accompanying text.

⁷⁹ "The anti-fraud provisions of the 1933 and 1934 Acts were aimed at the inequitable trade practices which were considered a cause of the loss of investor confidence which led to the stock market's malfunction in 1929." Mellett, *supra* note 5, at 1059; see also EDWARD C. FLETCHER, MATERIALS ON THE LAW OF INSIDER TRADING

Act, Congress conclusively determined that insider trading was not helpful to the market system and wanted the practice outlawed.⁸⁰ Congress thereby created the SEC and gave that agency both the power to regulate securities exchanges and the duty to preserve the general integrity of the markets.⁸¹ Congress entrusted the SEC with these powers along with broad mandates to regulate "in the public interest."⁸² It is against this backdrop that the *O'Hagan* court should have construed the government's development and reliance on the misappropriation theory. This history clearly demonstrates the differences between the cases relied upon by the *O'Hagan* court and criminal prosecutions under section 10(b). Necessity dictates that courts distinguish questions concerning the scope of the implied private cause of action under section 10(b),⁸³ from questions concerning governmental enforcement efforts.⁸⁴

45 (1991).

⁸⁰ See generally Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1994); Horman, *supra* note 5, at 2457 ("Insider trading was one of the major abuses that Congress perceived as a cause of the 1929 crash. Congress believed that fraudulent activities served 'no useful economic function' and caused 'great detriment to the investing public.' " (citing S. REP. NO. 73-792, at 3 (1934))); Mellett, *supra* note 5, at 1072-73 (explaining Congress' concern over deleterious effect of inequitable trade practices upon market); see also *supra* note 77 (explaining that Congress proscribed manipulative and deceptive practices that served "no useful function"). Congress criminalized insider trading despite arguments by some academics forwarding the notion that insider trading is a victimless activity and actually makes markets more efficient. See, e.g., Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 548-49 (1970) (positing that insider trading regulation hurts market efficiency and that such regulation is result of "outgrowth of frustration" rather than "cogent analysis.").

⁸¹ See 15 U.S.C. § 78d (1994) (establishing SEC); 15 U.S.C. § 78b (1994) (indicating securities transactions are "affected with a national public interest which makes it necessary to provide for regulation and control of ... transactions and ... practices and matters relat[ed]" to such transactions); 15 U.S.C. § 78f (1994) (granting SEC power to promulgate rules "necessary or appropriate in the public interest or for the protection of investors.").

⁸² 15 U.S.C. § 78j(b) (1994); see also *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (stating Exchange Act should be construed broadly to effectuate its remedial nature). Moreover, the general socio-economic and legislative history behind the enactment of the federal securities laws indicate that Congress intended for the anti-fraud provisions of the Exchange Act to be construed broadly. See *Chiarella v. United States*, 445 U.S. 222, 241 (1980) ("The very language of § 10(b) and Rule 10b-5 by repeated use of the word 'any' [was] obviously meant to be inclusive" (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972))).

⁸³ See *Central Bank of Denver v. First Interstate Bank*, 511 U.S. 164, 166 (1994) (stating courts have implied private rights of action enabling private plaintiffs to sue under section 10(b)).

⁸⁴ See *supra* notes 64-65 and accompanying text.

In choosing to undertake a highly captious analysis of the misappropriation theory, the *O'Hagan* court lost sight of the purposes of section 10(b) and stripped from Rule 10b-5 some of the adaptive power it has demonstrated for over fifty years.⁸⁵ Should the Supreme Court adopt the *O'Hagan* court's analysis, the SEC will be forced to seek legislative revision of the governing statutes in order to effectively comply with their original congressional mandate. In light of two recent failed attempts by

⁸⁵ See Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 *FORDHAM L. REV.* S7 (1993). Professor Langevoort posits that Rule 10b-5 has developed over fifty years to be an enduring and workable foundation from which to attack insider trading. *Id.* Professor Langevoort traced society's image of reality in the investing world since the late 1960's and asserted that changes in such social construction have affected the manner in which securities regulators and courts have viewed the role of Rule 10b-5. *Id.* at S12-S15. Professor Langevoort suggested that securities markets in the late 1960's were dominated by individual investors, perceived as powerless corporate governors. *Id.* at S11. Consequently, the role of Rule 10b-5, and securities regulation in general, was in the nature of consumer protection. *Id.* (citing *Santa Fe*, 430 U.S. at 473-74 (imposing deception requirement in 10b-5 actions); *Ernst & Ernst*, 425 U.S. at 214 (imposing scienter requirement in 10b-5 actions); *Blue Chip Stamps*, 421 U.S. at 748-49 (limiting parties able to bring 10b-5 private actions)). Professor Langevoort noted that the Supreme Court's curtailing of Rule 10b-5 in the 1970's was influenced by a conservatism in scholarly literature, and a general societal distrust for institutions. Langevoort, *supra*, at S12. Additionally, the shift toward the institutionalization of investment—through pension and mutual funds—which was previously undertaken on an individualized scale obviated the need for a consumer protection focus in Rule 10b-5 actions. *Id.* at S13. In the late 1970's and throughout the 1980's, economists and legal scholars promoted the hypothesis that markets were complex and efficient mechanisms that protected investors through speedy processing of vast information, and concomitant price correction. *Id.* During this period, securities regulation was viewed as an interference with the perceived total efficiency and self-correcting characteristics of the markets. *Id.* Professor Langevoort suggested that this "efficient market" theory contributed to the Supreme Court's decisions in *Chiarella*, 445 U.S. at 233-34, and *Dirks v. SEC*, 463 U.S. 646, 658 (1983), both of which noted a desire not to "chill" the dissemination of market information which benefits all investors. Langevoort, *supra*, at S14. Finally, Professor Langevoort noted the development, since the late 1980's, of the idea that the market is less than efficient, and often operates irrationally. *Id.* at S15. Professor Langevoort questioned whether there now exists yet another movement in Rule 10b-5 jurisprudence, toward "greater moralism and the assessment of blame on those who hold immense economic power and status [including institutions]." *Id.* at S15. Concluding that Rule 10b-5 has proven itself adaptable under such political and socio-economic shifts, Professor Langevoort posited that the Rule has not outlived its usefulness since "Rule 10b-5's intellectual wobble is the product not only of politics and emotion in the face of marketplace change, but the lack of convincing insight into the objective reality of investing." *Id.* at S16. This Comment asserts that the shifting landscape of investing and the attendant need for regulatory shift militates against an adherence to the *O'Hagan* analysis, which would likely force government regulators to seek a potentially narrow legislative definition of insider trading.

Congress to define insider trading,⁸⁶ it is likely that any such legislative proposals would be problematic. Any repudiation of the misappropriation theory by the Supreme Court will create a massive chasm in the government's enforcement net.⁸⁷ As the securities markets continue to grow in complexity and international scope,⁸⁸ the SEC will prosecute more insider trading violations than ever before.⁸⁹ An adoption of the *O'Hagan* analysis will lead to an undue restriction on the government's enforcement power at a critical point in the evolution of the securities markets, and will severely curtail the SEC's ability to regulate

⁸⁶ See *Improper Activities in the Securities Industry: Hearings Before the Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs*, 100th Cong., 4-5 (1987) (recounting importance of legislative attempt to define insider trading); Langenvoort, *supra* note 85, at S20 n.70 ("In 1987 and 1988, an ambitious effort was undertaken to define insider trading, and it received considerable support from the SEC, the private bar, and some members of Congress."); see also Jon R. Beeson, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1079 n.3 (1996) ("The term 'insider trading' has never been explicitly defined in the federal securities laws. Congress deliberated over whether to include the definition in the Insider Trading Sanctions Act of 1984, but ultimately determined that the existing substantive law, as developed by the courts, was adequately clear."). The SEC has expressed concern over the potential effects of a statutory definition on their enforcement program. The concern regards the loss of appropriately flexible standards, and the resulting inability of the government to redress future insider trading derivations. See Karl Groskaufmanis, *The SEC's Enforcement Nose Dive*, LEGAL TIMES, Dec. 16, 1991, at 21, 22.

⁸⁷ McLucas & Angotti, *supra* note 74, at 8 (stating repudiation of misappropriation theory has serious implications in governmental enforcement). Among the situations in which the SEC would have no authority to investigate include, by way of example: (a) trading in securities of target companies by insiders of acquiring companies, including lawyers, accountants, investment bankers, and traditional insiders such as officers and directors; (b) trading by insiders of a corporation in the debt issued by their corporation; (c) trading by employees of corporations in the securities of supplier corporations while armed with material nonpublic information concerning supplier agreements; and (d) trading by employees of investment firms based on unpublished research reports.

⁸⁸ See generally *SEC Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce, Internationalization of the Securities Markets* (1987) (noting large growth rate of international securities markets); Marc I. Steinberg & Daryl L. Lansdale Jr., *Regulation S and Rule 144A: Creating a Workable Fiction in an Expanding Global Securities Market*, 29 INT'L. LAW. 43 (1995) (evaluating SEC regulatory responses to rapid internationalization of securities markets).

⁸⁹ See generally Tracy Corrigan, *Insider Trading Cases Increasing*, FIN. TIMES, Sept. 20, 1996; *SEC: Insider Trading Increasing with Mergers*, SUN-SENTINEL (Ft. Lauderdale), June 25, 1995 (stating that SEC has more insider trading cases currently underway than ever before).

"in the public interest."⁹⁰

CONCLUSION

In *United States v. O'Hagan*, the Eighth Circuit became the second circuit court to reject the misappropriation theory. The *O'Hagan* court reasoned that the misappropriation theory failed to meet section 10(b)'s "deception" and "in connection with" requirements. The court failed to undertake a plenary review of section 10(b) language, choosing instead to rely on Supreme Court decisions of no precedential value in criminal prosecutions such as *O'Hagan*. Piecemeal language pulled from Supreme Court decisions regarding the implied private right of action under section 10(b) cannot form the basis for limiting the scope of government enforcement efforts. The lack of an applicable statutory alternative dictates that the Supreme Court should follow the lead of Congress by providing the government's enforcement program with statutory flexibility and accept the responsibility of weighing policy considerations under an ever changing market environment.

Timothy Sullivan

⁹⁰ See 15 U.S.C. § 78j(b) (1994).

