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Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan* Suggestion

DONNA M. NAGY*

For almost two decades, the United States Supreme Court was silent as to the validity of the so-called "fraud on the source" misappropriation theory of insider trading liability. This changed in June 1997 when the theory received a resounding endorsement from the Court in United States v. O'Hagan.

Critics of O'Hagan have argued that the Court's decision reaches too far. However, this Article contends that the Court actually endorsed a theory that does not reach far enough. By analyzing and critiquing the reasoning of the majority opinion in O'Hagan, this Article demonstrates that the Court's unnecessarily restrictive misappropriation theory will frustrate the prosecution of future cases involving trading on misappropriated information and may generate public mistrust of the SEC. This Article suggests a broader "fraud on investors" version of the misappropriation theory, contending that investors in the marketplace are also deceived and defrauded when a person purchases or sells securities based on material, nonpublic information that has been misappropriated from the information's source.

After more than seventeen years of uncertainty as to the validity of a "misappropriation theory" of insider trading liability,¹ the United States Supreme

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¹ In 1980, and again in 1987, the Government presented a misappropriation theory of insider trading liability to the Supreme Court, but a majority of the Court failed on both occasions to decide its merits. *See Chiarella v. United States*, 445 U.S. 222, 235–37 (1980); *Carpenter v. United States*, 484 U.S. 19, 24 (1987), discussed respectively *infra* text accompanying notes 28–42, 49–59, and notes 68–70. The Court also avoided consideration of a misappropriation theory by repeatedly denying certiorari in insider trading cases raising the issue. *See United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996), *cert. denied sub nom. United States v. Cusimano*, 117 S. Ct. 2509 (1997); *United States v. Libera*, 989 F.2d 596 (2d Cir.), *cert. denied sub nom. Sablone v. United States*, 510 U.S. 976 (1993); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992); *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992); *United States v. Grossman*, 843 F.2d 78 (2d Cir. 1988), *cert. denied*, 488 U.S. 1040 (1989); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983). The Court agreed to hear the issue in 1997 after a split had developed between the Second, Seventh, and Ninth Circuits (approving the validity of a misappropriation theory) and the Fourth and Eighth Circuits (rejecting the validity of a misappropriation theory). *See United States v. O'Hagan*, 117 S. Ct. 759 (1997) (granting writ

Court recently decided *United States v. O'Hagan*,² handing down a six member majority opinion that can only be described as a ringing endorsement of an argument long-championed by the Securities and Exchange Commission (the "SEC" or the "Commission"): that a person commits fraud in connection with a securities transaction, and thereby violates Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act")³ and SEC Rule 10b-5⁴ promulgated thereunder, when he or she trades securities based on material, nonpublic information that has been misappropriated in violation of a pre-existing duty of loyalty and confidentiality owed to the source of that information.⁵ Prior to *O'Hagan*, a majority of the Court had recognized Section 10(b) and Rule 10b-5 liability for insider trading only under the so-called "classical theory," which posits that these provisions are violated when corporate insiders trade in the shares of their corporation while in possession of material, nonpublic information.⁶ This more traditional theory of insider trading liability is based on the premise that insiders of a corporation, such as officers and directors, owe fiduciary duties to the corporation's shareholders.⁷ Thus, a corporate insider who

of certiorari); *see also infra* notes 60–81 and accompanying text (discussing circuit split).

² 117 S. Ct. 2199 (1997).

³ 15 U.S.C. § 78j(b) (1994). Section 10(b) makes it unlawful for any person, directly or indirectly:

To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, 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.

Id.

⁴ 17 C.F.R. § 240.10b-5 (1997). SEC Rule 10b-5 provides in pertinent part 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, [. . . or]

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

Id.

⁵ *See O'Hagan*, 117 S. Ct. at 2207.

⁶ *See Chiarella*, 445 U.S. at 228–30; *see also O'Hagan*, 117 S. Ct. at 2207 (identifying *Chiarella* as the source of the "classical" or "traditional" theory of insider trading liability).

⁷ *See Chiarella*, 445 U.S. at 227–28. The term "insider" is also used to describe persons such as attorneys, investment bankers, and other professionals who work as temporary agents

possesses material, nonpublic information is under an obligation either to disclose that information to the corporation's shareholders or to abstain from trading.⁸ Failure to do so constitutes fraud "in connection with" a securities transaction and violates Section 10(b) and Rule 10b-5.⁹

An example may be useful here to illustrate the fundamental difference between the classical and misappropriation theories. It is the classical theory of insider trading that would prohibit a hypothetical director of General Motors (GM) who learns confidential "good news" in the course of a GM board meeting from purchasing stock in GM. The classical theory, however, would not preclude the GM director from using that same confidential information in connection with her purchases of stock in Ford¹⁰—the GM director is an "outsider" to Ford and clearly does not owe duties of a fiduciary nature to Ford's shareholders. Because *O'Hagan's* misappropriation theory now extends liability under Section 10(b) and Rule 10b-5 to cover such instances of "outsider trading,"¹¹ the decision is considered to be "the most important securities law ruling in years."¹²

of the corporation (sometimes termed "temporary insiders" or "quasi-insiders"). See *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

⁸ See *Chiarella*, 445 U.S. at 228–29 (stating that the fiduciary relationship between an insider and the stockholders of his corporation gives rise to a duty to disclose in part because of the "necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of the uninformed minority stockholders") (quoting *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951)).

⁹ See *id.* at 227–31; *Dirks*, 463 U.S. at 653–64. Liability for insider trading under the classical theory also has been extended to certain "tippees," *i.e.*, those individuals who trade securities of a company while in possession of material, nonpublic information about that company (a "tip") that was conveyed by a corporate insider in violation of his fiduciary duty to the company's shareholders. See *id.* at 655–57. The theory here is that the tippee's duty to disclose or abstain from trading is derivative from that of the insider's duty owed to corporate shareholders. See *id.* at 659; see also *Chiarella*, 445 U.S. at 230 n.12 (recognizing that tippees of corporate insiders may be held liable under Section 10(b) because a disclosure obligation arises "from [their] role as a participant after the fact in the insider's breach of a fiduciary duty").

¹⁰ Assume, for instance, that the "good news" announced at the GM board meeting involved an innovative, and highly lucrative, confidential joint venture between GM and Ford.

¹¹ The term "outsider trading" is generally used to describe securities transactions by any person who is not an insider or temporary insider of the corporation whose securities are purchased. See *SEC v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991) (observing that "[t]he misappropriation theory extends the reach of Rule 10b-5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade").

¹² Linda Greenhouse, *Benchmarks of Justice*, N.Y. TIMES, July 1, 1997, at A1; see also Brett D. Fromson, *Justices Spell Out Insider Trading: Any Misuse of Confidential Information is Illegal*, *Supreme Court Rules*, WASH. POST, June 26, 1997, at C1 (describing *O'Hagan* as "the most significant securities fraud case in nearly two decades").

The classical and misappropriation theories of insider trading also delineate the particular parties that are deceived and defrauded “in connection with” securities trading based on material, nonpublic information. Under the classical theory, it is relatively easy to identify the victims of an insider’s violation of Section 10(b) and Rule 10b-5: the GM director who trades GM stock while in possession of material, nonpublic information deceives and defrauds those GM shareholders who sold their shares contemporaneously without full access to that information. But against whom is a fraud perpetrated when an outsider to a corporation uses confidential misappropriated information in connection with a securities transaction?

In *O’Hagan*, the Court clearly identified the “source of the information” as the victim of securities trading by a fiduciary who has misappropriated confidential information from her principal:¹³ the GM director who secretly uses the company’s confidential information to purchase stock in Ford would deceive and defraud GM within the meaning of Section 10(b) and Rule 10b-5. This is because, in the Court’s view, “a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in a breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.”¹⁴ Unfortunately, having identified the source of the confidential information as the person deceived and defrauded by a fiduciary who trades on the basis of misappropriated information, the *O’Hagan* Court failed to pursue an inquiry as to whether other parties may also have been deceived and defrauded by such securities trading.

This Article continues where *O’Hagan* left off and argues that investors in the marketplace are also deceived and defrauded when a person purchases or sells securities based on material, nonpublic information that has been misappropriated from the information’s source. Under this broader “fraud on investors” version of the misappropriation theory,¹⁵ such securities trading violates Section 10(b) and Rule 10b-5 because the unlawful act of misappropriating information from its rightful owner triggers an obligation to disclose to other investors in the marketplace or to abstain from trading securities

¹³ See *United States v. O’Hagan*, 117 S. Ct. 2199, 2207 (1997).

¹⁴ *Id.*

¹⁵ The *O’Hagan* Court noted that Chief Justice Warren Burger had advanced a “fraud on investors” type misappropriation theory in his dissenting opinion in *Chiarella*. See *id.* at 2208–09 n.6 (citing *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting)). Without addressing the merits of the Chief Justice’s theory, the *O’Hagan* Court commented only that “[t]he Government does not propose that we adopt a misappropriation theory of that breadth.” *Id.* Chief Justice Burger’s arguments in favor of a “fraud on investors” misappropriation theory, which, in turn, were likely influenced by arguments in the Government’s brief in *Chiarella*, are discussed *infra* notes 49–57 and accompanying text.

based on that misappropriated information.¹⁶ Acceptance of a fraud on investors misappropriation theory would mean that the GM director, using the company's confidential information to purchase stock in Ford, not only deceives and defrauds GM, but also those Ford shareholders who contemporaneously sold their stock in ignorance of the superior information that the director had misappropriated. For a number of reasons, this Article suggests that "the" misappropriation theory—*O'Hagan's* misappropriation theory—should be reframed to emphasize the fraud on investors rather than the fraud on the source.

The analysis in this Article proceeds in four parts. Part I focuses on the federal judiciary's development of classical and misappropriation theories of insider trading liability under Section 10(b) and Rule 10b-5. Part II turns to the Court's endorsement of the "fraud on the source" misappropriation theory in *O'Hagan* and examines both the majority and dissenting opinions. Part III analyzes *O'Hagan*, and highlights a number of fundamental problems with the Court's reasoning. In particular, Part III argues that *O'Hagan* endorsed an unnecessarily restrictive misappropriation theory that will frustrate the prosecution of future cases involving trading on misappropriated information; that the policy rationale used by the Court to support the "fraud on the source" theory is highly misleading and may generate public mistrust of the SEC; and that the "fraud on the source" theory is very difficult to reconcile with judicial and congressional determinations regarding standing in private insider trading actions for violations of Section 10(b) and Rule 10b-5. Part IV of this Article maintains that the text of Section 10(b) and Rule 10b-5 as well as prior Court precedents would support a misappropriation theory premised on the "fraud on the investors," and that such a theory, for a variety of different reasons, is far superior to the "fraud on the source" version announced in *O'Hagan*. Part IV concludes that *O'Hagan's* endorsement of a narrow misappropriation theory should not preclude lower courts from recognizing a broader one, and that

¹⁶ See *infra* Part IV.A (discussing both the common law and statutory basis for recognizing a disclosure obligation that is triggered by the misappropriation of information). Although the Government advanced only the fraud on the source version of the misappropriation theory in its brief to the Supreme Court in *O'Hagan*, both "fraud on the source" and "fraud on investors" misappropriation theories were proposed in an *amici* brief filed in support of the Government. See Brief of *Amici Curiae* North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842), available in 1997 WL 86236, at *10-14 [hereinafter NASAA Brief]. The NASAA Brief's arguments in favor of a "fraud on investors" misappropriation theory themselves reflected views expressed previously by at least one of the Brief's signatories. See Donald C. Langevoort, *Words from on High about Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 883-84 (1995) (favorably critiquing Chief Justice Burger's dissent in *Chiarella* and advocating judicial recognition of a misappropriation theory premised on the fraud that is perpetrated on other marketplace traders).

O'Hagan itself provides support for construing the text of Section 10(b) and Rule 10b-5 in light of the investor protection and market integrity policy objectives underlying the federal securities laws.

I. COMPLEMENTARY THEORIES OF INSIDER TRADING LIABILITY UNDER SECTION 10(b) AND RULE 10b-5

O'Hagan clarified the law of insider trading by clearly delineating two "complementary" approaches pursuant to which a person may be held liable under Section 10(b) and Rule 10b-5 for trading securities while in possession of material, nonpublic information: a classical theory and a misappropriation theory.¹⁷ Although the historical development of both theories has been examined extensively by other securities law scholars,¹⁸ a brief refresher is

¹⁷ See *O'Hagan*, 117 S. Ct. at 2207.

¹⁸ There is a vast amount of legal scholarship on the law of insider trading. The following constitutes only a fraction of the pre-*O'Hagan* articles that contain insightful discussions of the development of the classical and misappropriation approaches under Section 10(b) and Rule 10b-5: Barbara Bader Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 OHIO ST. L.J. 373 (1988) [hereinafter Aldave, *Carpenter and Its Aftermath*]; Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101 (1984) [hereinafter Aldave, *A General Theory*]; Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341 (1982); Douglas M. Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263 (1981); Jan G. Deutsch, *Chiarella v. United States: A Study in Legal Style*, 58 TEX. L. REV. 1291 (1980); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179 (1991); Dennis S. Karjala, *Federalism, Full Disclosure, and the National Markets in the Interpretation of Federal Securities Law*, 80 NW. U. L. REV. 1473 (1986); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1 (1982); Lawrence E. Mitchell, *The Jurisprudence of the Misappropriation Theory and the New Insider Trading Legislation: From Fairness to Efficiency and Back*, 52 ALB. L. REV. 775 (1988); Richard J. Morgan, *The Insider Trading Rules after Chiarella: Are They Consistent with Statutory Policy?*, 33 HASTINGS L.J. 1407 (1982); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1992); Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083 (1985); William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217 (1981). In addition to the articles cited *supra*, see generally RALPH C. FERRARA, DONNA M. NAGY, HEBERT THOMAS, FERRARA ON INSIDER TRADING AND THE WALL (1997) [hereinafter FERRARA ET AL.]. Much of the following description of the classical and misappropriation theories, as well as the description of *O'Hagan* in Part II *infra*, is based on the more extensive discussion in this treatise. For other comprehensive works on the subject of insider trading, see DONALD C. LANGEVOORT, INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION (1998); WILLIAM K.S. WANG &

nonetheless necessary to highlight a number of points that will play an important role in the analysis of *O'Hagan* that follows.

A. *The Development of the Classical Theory*

The Supreme Court entrenched the classical theory of insider trading liability in 1980, when it decided *Chiarella v. United States*.¹⁹ Prior to *Chiarella*, both the SEC²⁰ and the Second Circuit²¹ had broadly interpreted Section 10(b) and Rule 10b-5 to require any person in possession of any material, nonpublic information to disclose that information or to abstain from trading. This expansive approach to insider trading liability, which came to be known as the "parity of information theory,"²² was based on the dual notions that persons with

MARC I. STEINBERG, INSIDER TRADING (1996 & 1998 Supp.).

¹⁹ 445 U.S. 222 (1980).

²⁰ *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), presented the SEC with its first opportunity to address the application of Section 10(b) and Rule 10b-5 in the context of open market securities trading based on material, nonpublic information. Prior to *Cady, Roberts*, courts and the SEC had imposed liability under Section 10(b) and Rule 10b-5 only when insider trading occurred in face-to-face transactions between corporate insiders and shareholders. *See id.* at 908. In *Cady, Roberts*, the SEC imposed sanctions against a partner in a brokerage firm who had sold securities in the open market for client accounts on the basis of confidential "bad news" pertaining to a company; this confidential news was conveyed to him by his brokerage firm partner, who was a director of the company. The SEC found that trading while in possession of such material, nonpublic information violated Section 10(b) and Rule 10b-5. It noted that the obligation to disclose or to abstain from trading in the open market rests on two principal elements:

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

Id. at 912 (footnote omitted). In subsequent cases, the SEC soon began to highlight the second element it identified in *Cady, Roberts*, suggesting that the duty to disclose or abstain did not arise merely as an incident to a fiduciary relationship, but as a result of the "inherent unfairness" of using nonpublic information to reap personal trading profits. *See In re Investors Management Co.*, 44 S.E.C. 633 (1971) (imposing liability under Section 10(b) and Rule 10b-5 against non-insiders who had reason to know that the information they possessed was not publicly available).

²¹ *See SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (stating that "anyone in possession of material inside information must 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 inside information remains undisclosed"), *cert. denied*, 394 U.S. 976 (1969).

²² *See Chiarella*, 445 U.S. at 233-35 (declining to adopt "a parity of information rule").

access to material, nonpublic information have an “unerodable” informational advantage that no amount of insight, luck, or diligent research can overcome²³ and that the use of such an advantage in securities transactions is not only unfair but also fraudulent.²⁴ Thus, as the Second Circuit explained in *SEC v. Texas Gulf Sulphur*,²⁵ the parity of information theory²⁶ was grounded in “the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information.”²⁷

²³ See Victor Brudney, *Insiders, Outsiders and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 354–55 (1979). Professor Brudney was one of the first securities law scholars to advocate application of an “equality of access to information” theory to govern the legality of insider trading. In his view, the principal congressional purpose behind Section 10(b) was to protect investors in the marketplace from transactions that could be characterized as “overreaching.” See *id.* at 334, 336–37. Although he recognized that traditional corporate insiders were more likely than outsiders to be in a position giving them such “unerodable” advantages in trading, Professor Brudney maintained that *anyone* with such an advantage should be prohibited from profiting at the expense of public investors. See *id.* at 360. Thus, according to Professor Brudney, even a lawfully obtained “unerodable” information advantage could not be used in connection with a securities transaction. See *id.* For example, under his equality of access approach, Section 10(b) and Rule 10b-5 would prohibit a supplier who has knowledge of a significant increase in orders by a customer from purchasing stock in that customer because the supplier “has an informational advantage over the public in trading in the stock of the customer, an advantage which the public cannot overcome unless the customer is willing to disclose it [publicly].” *Id.* at 359.

²⁴ See *id.* at 333–39. Professor Brudney’s post-*O’Hagan* commentary indicates that he continues to favor interpreting Section 10(b) and Rule 10b-5 to prohibit all trading by persons who are in possession of material, nonpublic information (whether lawfully or unlawfully) that other securities traders “could not have discovered, purchased, or otherwise acquired.” Victor Brudney, *O’Hagan’s Problems*, SUP. CT. REV. 249, 256 (1997).

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

²⁶ Of course, a true “parity of information” rule would operate to ban virtually all securities trading because certain types of informational advantages, such as those that result from differences in diligence or intelligence, are inevitable. Thus, as Justice Blackmun noted in *Chiarella*, a more accurate characterization of the SEC’s and the Second Circuit’s theory would be a “parity of access to material information” rule. See *Chiarella*, 445 U.S. at 252 n.2 (Blackmun, J., dissenting). In the interest of brevity, this Article uses the phrase “parity of information” with the understanding that the focus is to be on the parity of access to information rather than the parity of information *per se*.

²⁷ *Texas Gulf Sulphur*, 401 F.2d at 848. At the opposite side of the academic spectrum from those advocating a parity of information approach to insider trading regulation are those securities law scholars who argue that insider trading should not be illegal. See, e.g., HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983). These commentators argue that insider trading is an effective and appropriate method of compensating insiders and entrepreneurs, see MANNE, *supra* at vii–viii, and that insider trading can benefit securities markets by increasing their allocative efficiency through a swift incorporation of new

In *Chiarella*, the Supreme Court determined, as a matter of statutory construction, that the mere possession of material, nonpublic information does not give rise to a general duty under Section 10(b) and Rule 10b-5 to disclose that information or abstain from trading.²⁸ The case involved the now infamous actions of Vincent Chiarella, an employee of a financial printer engaged to print announcements of a number of corporate takeover bids.²⁹ Although the identity of both the acquiring and target corporations had been concealed by code names until the night of the final printing, Chiarella had managed to decipher the identity of the companies from other facts provided in the materials supplied to the printer by the acquiring companies. Chiarella then purchased securities in the target companies and sold them immediately after the takeover attempts were made public, for a total profit of about \$30,000.³⁰ He was indicted and convicted for violating Section 10(b) and Rule 10b-5.³¹ The Second Circuit affirmed his conviction, holding that “[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information . . . without incurring an affirmative duty to disclose.”³²

The Supreme Court reversed Chiarella’s conviction.³³ In a majority opinion joined by four other members of the Court, Justice Lewis Powell reasoned that “a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information”³⁴ because “[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.”³⁵ Quoting the Restatement (Second) of Torts, the Court maintained that such a disclosure duty arises when one party has information “that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between

information in the marketplace. See Carlton & Fischel, *supra* at 861–72. Both of these justifications have been subjected to substantial criticism. See, e.g., Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 627–42 (1984); Robert J. Haft, *The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation*, 80 MICH. L. REV. 1051, 1067–71 (1982); Ray A. Schotland, *Unsafe at Any Price: A Reply to Henry Manne, Insider Trading and the Stock Market*, 53 VA. L. REV. 1425 (1967).

²⁸ See *Chiarella*, 445 U.S. at 235.

²⁹ See *id.* at 224.

³⁰ See *id.*

³¹ Insider trading can be criminally prosecuted by the Justice Department under 15 U.S.C. § 78ff(a), which provides for criminal penalties for any willful violation of any provision of the Exchange Act or any rule or regulation thereunder. *Chiarella* was the first attempt by federal prosecutors to invoke this provision in an insider trading case.

³² United States v. Chiarella, 588 F.2d 1358, 1365 (2d. Cir. 1978).

³³ See *Chiarella*, 445 U.S. at 225.

³⁴ *Id.* at 235.

³⁵ *Id.*

them.”³⁶ As the employee of a financial printer hired by the acquiring corporations, Chiarella owed fiduciary duties neither to the target corporations nor to their shareholders.³⁷ The Court therefore concluded that Chiarella’s silence in securities transactions with target shareholders was not fraudulent within the meaning of Section 10(b) and Rule 10b-5.³⁸

The *Chiarella* Court then went on to critique directly the reasoning upon which the parity of information theory was based.³⁹ According to the Court, the theory was grounded on two shaky assumptions. First, the theory assumes that transactions based on unequal access to material, nonpublic information are inherently fraudulent. The Court rejected this assumption, maintaining that “not every instance of financial unfairness constitutes fraudulent activity under § 10(b).”⁴⁰ Likewise, the theory assumes that all marketplace traders are under a general duty to refrain from trading on certain information merely because such information is material and not publicly available. The Court declined the invitation to impose “such a broad duty” because it was contrary to “the established doctrine that duty arises from a specific relationship between two

³⁶ *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). For an argument that Justice Powell’s statement overlooks other, equally well recognized, exceptions triggering disclosure obligations in business transactions, see *infra* note 310 and accompanying text.

³⁷ See *Chiarella*, 445 U.S. at 232–33. Here, Justice Powell appears to assume that, under the common law, directors and officers owed duties of a fiduciary nature to shareholders (in addition to the corporation itself) and that the existence of a fiduciary relationship between an insider and corporate shareholders triggered a duty to disclose in anonymous open market transactions (as opposed to face-to-face transaction where reliance could be demonstrated). Yet neither assumption would have been recognized as the common law majority rule prior to 1934. See Seligman, *supra* note 18, at 1091–1103; see also Theresa A. Gabaldon, *State Answers to Federal Questions: The Common Law of Federal Securities Regulation*, 20 J. CORP. L. 155, 160 (1994) (concluding that Justice Powell’s approach was “more than a little unsatisfactory, given that states typically imposed *no* such generalized duty of disclosure before the federal courts began to suggest its existence”). Thus, in this regard, *Chiarella* itself constituted a broad interpretation of the common law. See *infra* text accompanying notes 353–54.

³⁸ See *Chiarella*, 445 U.S. at 234–35.

³⁹ The *Chiarella* Court also acknowledged the lower court’s specific contention that its “‘regular access to information’ test would create a workable rule embracing ‘those who occupy . . . strategic places in the market mechanism.’” *Chiarella*, 445 U.S. at 231 n.14 (quoting *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978)). But the Court rejected this test, maintaining that “[t]hese considerations are insufficient to support a duty to disclose” and that such “[a] duty arises from the relationship between parties and not merely from one’s ability to acquire information because of his position in the market.” *Chiarella*, 445 U.S. at 231 n.14 (citations omitted).

⁴⁰ *Id.* at 232 (citing *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474–77 (1977)).

parties,” and Congress had not expressed an intention to depart from the common law.⁴¹ On these points, Justice Harold Blackmun (joined by Justice Thurgood Marshall) vehemently disagreed, arguing in a dissenting opinion that the “narrow construction” placed upon Section 10(b) and Rule 10b-5 by the majority reflected “a position opposite to the expectations of Congress at the time the securities laws were enacted.”⁴²

Three years after *Chiarella*, in *Dirks v. SEC*,⁴³ the Court once again emphasized that liability under the classical theory of insider trading turns on the existence of a fiduciary obligation owed to the shareholders with whom the defendant is trading. The conduct at issue involved a “tip” by Ronald Secrist, a former officer of Equity Funding of America (“Equity Funding”), to investment analyst Raymond Dirks.⁴⁴ Secrist told Dirks that Equity Funding’s assets were vastly overstated as a result of fraudulent corporate practices. Dirks then investigated this tip, and after confirming its truth, advised his clients and other investment analysts to sell off their stock in Equity Funding.⁴⁵ In an administrative proceeding against Dirks, the SEC concluded that “[w]here ‘tippees’—regardless of their motivation or occupation—come into possession of material ‘corporate information that they know is confidential and know or should know came from a corporate insider,’ they must either publicly disclose that information or refrain from trading.”⁴⁶ The Supreme Court disagreed, holding that “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 shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.”⁴⁷

⁴¹ *See id.* at 233.

⁴² *Id.* at 248 (Blackmun, J., dissenting); *see also id.* at 251 (“I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantages through trading in affected securities.”).

⁴³ 463 U.S. 646 (1983).

⁴⁴ *See id.* at 648–51.

⁴⁵ *See id.* at 649. Clearly evidencing the validity of the adage “no good deed goes unpunished,” Dirks also reported to the SEC his findings with respect to Equity Funding’s fraudulent practices. *See id.* at 650 n.3.

⁴⁶ In the Matter of Raymond L. Dirks, 21 SEC Docket 1401, 1407 (1981) (quoting *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980)).

⁴⁷ *Dirks*, 463 U.S. at 660. The Court was particularly concerned that imposing liability against Dirks would have a chilling effect on other market participants, particularly investment analysts, and that this would discourage them from investing their time and resources in “ferret[ing] out and analyz[ing] information.” *Id.* at 658 (quoting *Dirks*, 21 SEC Docket at 1406). The Court further noted that such information is often “the basis for judgments as to the market worth of a corporation’s securities” and that this type of information “cannot be made

The Court then concluded that Dirks did not violate Section 10(b) and Rule 10b-5 because Secrist's tip to Dirks did not violate his fiduciary duty to the shareholders of Equity Funding.⁴⁸

B. *The Development of a Misappropriation Alternative*

1. *Views Expressed in Chiarella*

A misappropriation alternative to the classical theory of insider trading was raised by the Government in its brief to the Supreme Court in *Chiarella*, where it argued that Chiarella had "committed fraud against both the acquiring corporations whose information he converted and the investors who sold him securities in ignorance of forthcoming market events of critical importance."⁴⁹ Specifically, the Government contended that Chiarella's "secret conversion of confidential information operated as a fraud on the corporation that entrusted him with that information"⁵⁰ and also that his "purchase of securities based on material nonpublic information obtained by misappropriation constituted fraud on the sellers of those securities."⁵¹ Yet the *Chiarella* majority did not rule on the validity of either of these theories because, in its view, the theories had not been presented to the jury.⁵² Misappropriation theories, however, were discussed at length by a total of five Justices in separate concurring or dissenting opinions.

Chief Justice Warren Burger and Justices William Brennan, Blackmun, and Marshall agreed that liability under Section 10(b) and Rule 10b-5 would be triggered by any person who unlawfully obtained or converted for his own

simultaneously available to all of the corporation's stockholders or the public generally." *Id.* at 659.

⁴⁸ *See id.* at 665. The Court explained that whether an insider's disclosure of confidential information to a third party is a breach of duty depends "in large part on the purpose of the disclosure." *Id.* at 662. This involves an inquiry into "whether the insider would personally benefit, directly or indirectly, from the disclosure." *Id.* The Court also noted that this "direct or indirect personal benefit" test requires a court to focus on a variety of objective factors, citing examples such as whether the tip could be considered a *quid pro quo* or whether the insider made a gift of confidential information to a trading relative or friend. *See id.* at 663. Applying this analysis to Secrist's disclosure to Dirks, the Court concluded that Secrist did not breach his fiduciary duty to Equity Funding's shareholders because Secrist was motivated by a desire to expose an illegal fraud rather than by a desire to obtain any direct or indirect personal benefit. *See id.* at 666-67.

⁴⁹ Brief for Respondent United States at 24, *Chiarella v. United States*, 445 U.S. 222 (1979) (No. 78-1202), available in LEXIS.

⁵⁰ *Id.* at 28.

⁵¹ *Id.* at 38-39.

⁵² *See Chiarella*, 445 U.S. at 236.

benefit nonpublic information which he then used in connection with the purchase or sale of securities.⁵³ Thus, four Justices in *Chiarella* endorsed a broad version of the misappropriation theory that recognized a general disclosure obligation running to those investors with whom the misappropriator trades: “a person who has misappropriated nonpublic information has an absolute duty to disclose that information or refrain from trading.”⁵⁴

It was Chief Justice Burger’s dissenting opinion that most clearly elucidated this “fraud on investors” misappropriation theory. He opined:

As a general rule, neither party to an arm’s-length business transaction has an obligation to disclose information to the other unless the parties stand in some confidential or fiduciary relation. This rule permits a businessman to capitalize on his experience and skill in securing and evaluating relevant information; it provides incentive for hard work, careful analysis, and astute forecasting. But the policies that underlie the rule should also limit its scope. In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.⁵⁵

To support his view of the requirements at common law, Chief Justice Burger quoted Dean Page Keeton’s observation that “[a]ny time information is acquired by [] an illegal act it would seem that there should be a duty to disclose that information.”⁵⁶ Accordingly, Chief Justice Burger concluded that *Chiarella* owed the target shareholders a duty to disclose or to refrain from trading by virtue of the fact that he “misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence.”⁵⁷

A fifth member of the *Chiarella* Court, Justice John Paul Stevens, advanced an alternative misappropriation theory that focused on *Chiarella*’s possible fraud on the source of the information. Justice Stevens indicated that while he did not

⁵³ See *id.* at 238–39 (Brennan, J., concurring in the judgment) (endorsing a broad misappropriation theory, but agreeing with the majority that misappropriation instructions had not been presented to the jury), 239–43 (Burger, C.J., dissenting) (endorsing a broad version of the misappropriation theory and contending that the theory was properly presented to the jury), 245–46 (Blackmun, J., joined by Marshall, J., dissenting) (endorsing the more expansive parity of information theory, see *supra* notes 22–23, 42 and accompanying text, but noting that *Chiarella*’s trading on misappropriated confidential information “is the most dramatic evidence that [he] was guilty of fraud”).

⁵⁴ *Id.* at 240 (Burger, C.J., dissenting).

⁵⁵ *Id.* at 239–40 (citations omitted).

⁵⁶ *Id.* at 240 (quoting Page W. Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25–26 (1936)). For a more extensive discussion of Dean Keeton’s interpretation of disclosure requirements under the common law, see *infra* text accompanying notes 322–23.

⁵⁷ *Id.* at 245.

accept the existence of a general duty owed to all securities investors on the other side of Chiarella's transactions, "[r]espectable arguments could be made" that Chiarella's action constituted a fraud or deceit on the acquiring companies that entrusted confidential tender offer information to his employer, and that this fraud or deceit occurred "in connection with the purchase or sale of any security."⁵⁸ Justice Stevens's concurring opinion therefore raised the possibility of a narrow version of the misappropriation theory. Yet he thought the Court wise for "leav[ing] the resolution of this issue for another day."⁵⁹

2. *Conflicting Federal Appellate Views Regarding the "Fraud on the Source" Theory*

Encouraged in part by the positive signals sent by multiple members of the Supreme Court in *Chiarella*, the SEC and the Justice Department soon began to embrace a misappropriation theory of insider trading liability in instances where the Government wished to pursue Section 10(b) and Rule 10b-5 actions against persons who did not owe fiduciary duties to the shareholders of the companies in which securities transactions were made. Specifically, the Government began to emphasize the argument advanced by Justice Stevens in *Chiarella*; namely, that trading securities based on material, nonpublic information obtained in breach of a pre-existing duty of confidentiality constituted a fraud or deceit against the source of the information in connection with the purchase or sale of securities.

*United States v. Newman*⁶⁰ presented the Government with an opportunity to litigate this "fraud on the source" misappropriation theory of insider trading liability. The case involved a scheme by two employees of Morgan Stanley Inc. and Lehman Brothers Kuhn Loeb Inc. who channeled confidential information about their employers' investment banking activities to third parties. These third parties then engaged in securities transactions based on this confidential information. Both the employees and their tippees were prosecuted under Section 10(b) and Rule 10b-5 for the tippees' purchases of stock in tender offer targets based on confidential information given to the investment banks by the acquiring companies. The Second Circuit found that the entire scheme (both the tipping and the trading) defrauded the investment bank employers as well as their respective clients.⁶¹ The court further concluded that the defendants' fraud and deception occurred "in connection with" the purchase of securities because the employees' and the third party traders' "sole purpose in participating in the

⁵⁸ *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring).

⁵⁹ *Id.*

⁶⁰ 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

⁶¹ *See id.* at 17.

misappropriation of confidential takeover information was to purchase shares of the target companies."⁶²

After its decision in *Newman*, the Second Circuit continued to apply the misappropriation theory in cases involving corporate outsiders, premising each finding of liability on the fraud that was perpetrated on the source of that information.⁶³ The Second Circuit further extended the misappropriation theory in *United States v. Carpenter*.⁶⁴ The case involved a *Wall Street Journal* reporter who had leaked information about his upcoming "Heard on the Street" columns to two stockbrokers who, based on these tips, purchased securities in companies that were to receive favorable press.⁶⁵ The Second Circuit had little trouble concluding that the tipper's and tippees' scheme deceived and defrauded the *Wall Street Journal* within the meaning of Section 10(b) and Rule 10b-5, even though the *Wall Street Journal* had no relationship to or interest in the companies whose securities were traded.⁶⁶ The Second Circuit also affirmed the defendants' convictions under federal mail fraud and wire fraud statutes.⁶⁷

⁶² *Id.* at 18.

⁶³ *See, e.g.*, *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984) (injunction and disgorgement affirmed in a case against a financial printer involving facts almost identical to those of *Chiarella*), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990) (applying misappropriation theory against psychiatrist who allegedly traded on the basis of material, nonpublic information concerning a corporate executive's activities learned in the course of treating the wife of the corporate executive); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y.) (applying misappropriation theory against son who allegedly traded on the basis of nonpublic information obtained from father, a corporate director), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) (enjoining tippees of an administrative staff employee of law firm who purchased shares of companies targeted for takeover by the law firm's clients). *But see* *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) (en banc) (finding that, although the misappropriation theory may be used to impose liability under Section 10(b) and Rule 10b-5 upon a breach of trust among family members who share business confidences, the Government failed to offer sufficient evidence of such a relationship between a wife and her husband), *cert. denied*, 503 U.S. 1004 (1992).

⁶⁴ 791 F.2d 1024 (2d Cir. 1986); *see* *Carpenter v. United States*, 484 U.S. 19 (1987) (affirming Carpenter's convictions under the securities laws by an equally divided court).

⁶⁵ *See* *Carpenter*, 791 F.2d at 1026-27.

⁶⁶ *See id.* at 1033-34. Although in the mid-1980s *Carpenter* was viewed as an "unusual case," *see* Aldave, *Carpenter and its Aftermath*, *supra* note 18, at 381, its fact pattern soon became a more common basis for prosecution under Section 10(b) and Rule 10b-5. *See, e.g.*, *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995) (criminal action for alleged violations of Section 10(b) and Rule 10b-5 by government official who traded securities on the basis of confidential information misappropriated from government agency that had no interest in the securities that were traded).

⁶⁷ *See* *Carpenter*, 791 F.2d at 1034-36. The mail and wire fraud statutes, 18 U.S.C.

Although the Supreme Court agreed to review the Section 10(b) and Rule 10b-5 convictions as well as the defendants' mail and wire fraud convictions, the Court's opinion in *Carpenter v. United States*⁶⁸ focused almost entirely on mail and wire fraud.⁶⁹ With respect to the long awaited issue of the validity of the "fraud on the source" misappropriation theory, the Court offered but one sentence: "The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts."⁷⁰

Despite its failure to capture an endorsement by a majority of the Court in *Carpenter*, the "fraud on the source" version of the misappropriation theory was thereafter accepted by the Seventh,⁷¹ Ninth,⁷² and—arguably—Third Circuits.⁷³

§§ 1341, 1343, prohibit the use of mails or wire communication to further a scheme to defraud.
See id.

⁶⁸ 484 U.S. 19 (1987).

⁶⁹ *See id.* at 24–27.

⁷⁰ *Id.* at 24. The Court split 4-4 on this issue; the seat vacated by Justice Powell had not yet been filled by Justice Anthony Kennedy. Had Justice Powell remained on the Court that decided *Carpenter*, the misappropriation theory would likely have had a clear five votes against its validity. Initially, the Court had voted to deny certiorari, and Justice Powell had prepared and circulated a draft dissent from that denial. *See* Draft of Dissent from the Denial of Certiorari for *Carpenter v. United States*, Justice Powell (Dec. 10, 1986) [hereinafter Powell Draft Dissent], reprinted in A.C. Pritchard, *United States v. O'Hagan: Agency Law & Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 55–58 (1998). Justice Powell's Draft Dissent conveyed his opposition to the misappropriation theory, reasoning that the theory was inconsistent with *Chiarella* and *Dirks* because the relevant inquiry under Section 10(b) and Rule 10b-5 "must focus on 'petitioner's relationship with the sellers of the . . . securities . . .'" Powell Draft Dissent at 6 (quoting *Chiarella v. United States*, 445 U.S. 222, 233 (1987)), reprinted in Pritchard, *supra*, at 58. The Court then re-voted and granted certiorari. *See* *Carpenter v. United States*, 479 U.S. 1016 (1986). Justice Powell's retirement, however, took effect before *Carpenter* was argued before the Court the following term.

⁷¹ *See* SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991) (misappropriation theory applied in action against an individual who broke into his former place of employment to steal nonpublic information about his former employer's clients and then used that information to trade securities), *cert. denied*, 502 U.S. 1071 (1992); SEC v. Maio, 51 F.3d 623, 634 (7th Cir. 1995) (applying misappropriation theory to affirm the conviction of tippees who purchased securities of target corporation based on tip provided by officer of acquiring corporation).

⁷² *See* SEC v. Clark, 915 F.2d 439, 445 (9th Cir. 1990) (misappropriation theory applied to employee who tipped and traded in the securities of a company he knew to be a takeover target of his employer).

⁷³ *See* Rothberg v. Rosenbloom, 771 F.2d 818, 822–23 (3d Cir. 1985) (tippee's trading on the basis of confidential merger information obtained from corporate official violated Rule 10b-5), *rev'd on other grounds after remand*, 808 F.2d 252 (3d Cir. 1986). *But see* SEC v. Lenfest, 949 F. Supp. 341, 345 (E.D. Pa. 1996) (expressing uncertainty as to whether the Third Circuit actually applied the misappropriation theory in *Rothberg*, but nonetheless recognizing

Thus, for many years, dissension over the theory's validity stemmed not from courts but rather from academic scholars.⁷⁴

The unanimity among the federal circuits regarding the validity of the "fraud on the source" misappropriation theory dissipated in 1995 when the Fourth Circuit decided *United States v. Bryan*.⁷⁵ The defendant in that case, Elton "Butch" Bryan, was a former director of the West Virginia Lottery. On the basis of confidential information entrusted to him in his official capacity, Bryan purchased the stock of companies that were slated to receive contracts from the Lottery Commission.⁷⁶ The Fourth Circuit overturned Bryan's conviction for violating Section 10(b) and Rule 10b-5, concluding that while Bryan violated a fiduciary duty owed to his employer, breach of that duty did not constitute deceptive or manipulative conduct "in connection with the purchase or sale of [a] security."⁷⁷ In the Fourth Circuit's view, the text of these provisions would be stretched beyond recognition were liability imposed in instances where the "'defrauded' person has no connection with a securities transaction, [and] where no investor or market participant has been deceived."⁷⁸

the validity of that theory in denying defendant's motion for summary judgment).

⁷⁴ See, e.g., C. Edward Fletcher III, *The "In Connection With" Requirement of Rule 10b-5*, 16 PEPP. L. REV. 913, 922-29 (1989) (questioning whether the "in connection with" requirement of Rule 10b-5 is met in misappropriation cases); Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 91 (1984) (arguing that the misappropriation theory is a "misconceived effort to broaden the narrow focus of the insider trading doctrine"); Carole B. Silver, *Penalizing Insider Trading: A Critical Assessment of the Insider Trading Sanctions Act of 1984*, 1985 DUKE L.J. 960, 983-84 (1985) (concluding that the misappropriation theory conflicts with *Chiarella* by disassociating a fraudulent act from an investor's decision to purchase or sell); Manning Gilbert Warren III, *Who's Suing Who? A Commentary on Investment Bankers and the Misappropriation Theory*, 46 MD. L. REV. 1222, 1248 (1987) (arguing that the "misappropriation theory . . . works a serious distortion of [R]ule 10b-5 jurisprudence").

⁷⁵ 58 F.3d 933 (4th Cir. 1995).

⁷⁶ See *id.* at 937-39.

⁷⁷ *Id.* at 944.

⁷⁸ *Id.* at 950. The Fourth Circuit's opinion in *Bryan* sparked a new wave of commentary critical of the misappropriation theory. See, e.g., Michael P. Kenney & Theresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 188 (1995) (contending that "whatever irresistible force" brings together a misappropriator's so-called "fraud on the source" and his securities transactions, it is "not the magnetic attraction of the statutory text"); John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1138 (1996) (stating that "it is only through considerable legal gymnastics that the misappropriation theory leaps from the requirement of finding a breach of a duty unrelated to the market, to a holding that causation of remote and indirect harm to investors in the market is the basis for Rule 10b-5 liability").

The following year, in an opinion adopting the Fourth Circuit's *Bryan* analysis "in its entirety as [its] own,"⁷⁹ the Eighth Circuit rejected the validity of the misappropriation theory.⁸⁰ In response to what was then a clear split in the federal circuits, the Supreme Court agreed to hear the Government's appeal of the Eighth Circuit's decision in *United States v. O'Hagan*.⁸¹

3. *The Pre-O'Hagan Status of the "Fraud on Investors" Theory*

Before turning to an analysis of the Supreme Court's decision in *United States v. O'Hagan*, it is useful to pause and consider what became of the alternative version of the misappropriation theory that premised liability on a trader's duty to disclose his misappropriated information to the other traders in the marketplace—the version suggested by the SEC in *Chiarella* and subsequently endorsed by Chief Justice Burger and three other members of the Court.⁸² One could speculate that after this encouraging signal in *Chiarella*, the Government was well poised to advance "a fraud on investors" theory in *United States v. Newman*,⁸³ its first post-*Chiarella* opportunity to litigate a misappropriation theory. Yet the Government chose not to litigate a "fraud on investors" misappropriation theory, opting instead to argue only that the tippees and tippees defrauded the investment banks and their clients within the meaning of Section 10(b) and Rule 10b-5.⁸⁴ Perhaps the Government feared that presenting alternative theories would confuse the jury and trigger an acquittal,⁸⁵ or may have presumed that the "fraud on the source" theory was the easier one for juries to understand and apply.⁸⁶

⁷⁹ *United States v. O'Hagan*, 92 F.3d 612, 620 (8th Cir. 1996).

⁸⁰ *See id.*

⁸¹ 117 S. Ct. 759 (1997) (granting writ of certiorari).

⁸² *See supra* notes 53–57 and accompanying text.

⁸³ 664 F.2d 12 (2d Cir. 1981).

⁸⁴ *See Langevoort, supra* note 16, at 883 (noting that Chief Justice Burger's misappropriation theory "was deliberately not pursued in *Newman*").

⁸⁵ *See id.*

⁸⁶ After *Chiarella* and *Dirks*, securities law scholars expressed differing opinions with respect to the viability of the Chief Justice's misappropriation theory. Compare Aldave, *A General Theory, supra* note 18, at 115 (observing that lower courts failed to embrace the broader theory, and contending that the Chief Justice's authority for the theory consisted of a single citation to a law review article that argued that "'there *should* be a duty,' not that there *is* a duty, to disclose information that was illegally acquired") (quoting Burger quoting Keeton, *supra* note 56, at 240), and *id.* at 116 (contending that the Chief Justice's theory "appears to be inconsistent with the language and reasoning of *Chiarella* and *Dirks*"), with Langevoort, *supra* note 16, at 883 (discussing advantages of Chief Justice Burger's theory and contending that recognition of the theory would "require some revisionism, but there is ample cover").

Less than two years after the Second Circuit decided *Newman*, the underlying facts of the case presented another opportunity for judicial consideration of the "fraud on investors" version of the misappropriation theory, when a private cause of action under Section 10(b) and Rule 10b-5 was instituted against the investment banks' employees and their tippees who had been criminally convicted.⁸⁷ The private plaintiff in *Moss v. Morgan Stanley Inc.*⁸⁸ had unwittingly sold stock in the open market prior to the public announcement of a tender offer for that stock.⁸⁹ The plaintiff argued that because both the tippers and tippees had violated Section 10(b) and Rule 10b-5, they were liable for the loss he suffered in selling his stock. At the pleadings stage, the defendants successfully argued that the case should be dismissed because their disclosure duties under Section 10(b) and Rule 10b-5 ran only to the source of the information.⁹⁰ Plaintiff Moss appealed the dismissal to the Second Circuit.

Significantly, the SEC filed with the Second Circuit an *amicus curiae* brief supporting Moss's argument that he was entitled to damages, and developing more fully the "fraud on investors" misappropriation theory that Chief Justice Burger outlined in his *Chiarella* dissent.⁹¹ The Second Circuit, nonetheless, affirmed the district court's dismissal.⁹² The court determined that the selling shareholder had not been deceived and defrauded by the defendants because, under the majority opinion in *Chiarella*, "defendants owed no duty of disclosure to plaintiff Moss."⁹³ The court further opined that Moss could not obtain standing under Rule 10b-5 by riding "piggyback upon the duty owed by

⁸⁷ See *supra* notes 60–62 and accompanying text.

⁸⁸ 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

⁸⁹ See *id.* at 8.

⁹⁰ See *id.* at 9–12.

⁹¹ See Brief of the Securities Exchange Commission, *Amicus Curiae*, at 11–22, *Moss v. Morgan Stanley Inc.*, 719 F.2d 5 (2d Cir. 1983) (No. 83-7120) (copy on file with author). The SEC summarized its argument as follows:

A person who misappropriates material nonpublic information owes a duty to investors not to trade on the basis of that undisclosed information (whether the information may be viewed as insider information or market information). Because defendant Newman in this case purchased shares of [the target] on the basis of market information which he knew had been misappropriated from the tender offeror, the selling shareholders of [the target] were defrauded under Section 10(b) of the Securities Exchange Act and Rule 10b-5. This conclusion is consistent with the decision of the Supreme Court in *Chiarella v. U.S.*, as well as the decision of this [c]ourt in *U.S. v. Newman*, the common law of fraud, and the language, legislative history, and purposes of the federal securities laws.

Id. at 11–12 (citations omitted).

⁹² See *Moss*, 719 F.2d at 23.

⁹³ *Id.* at 16.

defendants to [their investment bank employers].”⁹⁴ According to the Second Circuit, imposition of civil liability in this private action “would grant [the plaintiff] a windfall recovery simply to discourage tortious conduct by securities purchasers.”⁹⁵ And in the court’s view, “the Supreme Court has made clear that [S]ection 10(b) and [R]ule 10b-5 protect investors against *fraud*; they do not remedy every instance of undesirable conduct involving securities.”⁹⁶

Within a few years, Congress reacted to the Second Circuit’s ruling in the *Moss* case by amending the Exchange Act to provide contemporaneous traders, such as Moss, with an express right of action under Section 20A.⁹⁷ Congress’s response to *Moss* therefore overturned the Second Circuit’s holding as a practical matter—Section 20A provides plaintiffs with *express* standing to sue any individual who violates any provision of the Exchange Act by trading securities while in possession of material, nonpublic information.⁹⁸ Yet, because the case involved the validity of an *implied* private right of action under Rule 10b-5, *Moss*’s holding that shareholders are not owed a disclosure duty by an outsider trading on misappropriated information continues to be cited with approval.⁹⁹

Moss’s holding, however, was significantly weakened by the Second Circuit in *United States v. Carpenter*,¹⁰⁰ where in stark contrast to *Moss*, the court advanced the argument that an outsider’s securities trading based on information misappropriated from an employer constituted not only a fraud on the source but also a fraud on investors. In an often overlooked part of the *Carpenter* decision,¹⁰¹ the Second Circuit maintained that because the reporter and his tippees breached a duty of confidentiality owed to the *Wall Street Journal*, these defendants had “a *corollary duty*, which they breached, under [S]ection 10(b) and Rule 10b-5, to abstain from trading in securities on the basis of the

⁹⁴ *Id.* at 13 (quoting *Moss v. Morgan Stanley Inc.*, 553 F. Supp. 1347, 1353 (S.D.N.Y. 1983)).

⁹⁵ *Id.* at 16.

⁹⁶ *Id.*

⁹⁷ 15 U.S.C. § 78u-1 (1994).

⁹⁸ 15 U.S.C. at § 78u-1(a). For a discussion of Section 20A and its implications for a “fraud on investors” misappropriation theory, see *infra* notes 289–95, 298–302 and accompanying text.

⁹⁹ See *SEC v. Clark*, 915 F.2d 439, 445 n.8 (9th Cir. 1990) (noting that “the Second Circuit correctly rejected Chief Justice Burger’s version of the misappropriation theory as contrary to the holdings in *Chiarella* and *Dirks*”) (citing *Moss v. Morgan Stanley Inc.*, 719 F.2d 5, 16 (2d Cir. 1983)).

¹⁰⁰ 791 F.2d 1024 (2d Cir. 1986).

¹⁰¹ For example, although the Ninth Circuit in *Clark* cited both *Moss* and *Carpenter* with approval, it made no mention of the latter’s recognition of the very disclosure duty that was rejected in *Moss*. See *Clark*, 915 F.2d at 445.

misappropriated information or to do so only upon making adequate disclosure *to those with whom they traded.*"¹⁰² Because the actual holding in *Carpenter* turned on the fraud that was perpetrated on the *Wall Street Journal*, the Second Circuit apparently considered it unnecessary to reconcile its "fraud on investors" dicta with its contrary holding in *Moss*.¹⁰³

II. UNITED STATES V. O'HAGAN

The Supreme Court's opinion in *United States v. O'Hagan*¹⁰⁴ resoundingly endorsed the "fraud on the source" version of the misappropriation theory. Five members of the Court joined in the majority opinion authored by Justice Ruth Bader Ginsburg. The dissents consisted of a brief opinion by Justice Antonin Scalia, and a lengthier, more strongly worded opinion by Justice Clarence Thomas joined by Chief Justice William Rehnquist.

A. O'Hagan's Securities Purchases Based on Misappropriated Information

The facts of *O'Hagan* involved trading in the securities of a tender offer target company by an attorney whose law firm represented the prospective bidder.¹⁰⁵ In July 1988, James O'Hagan, a partner with the Minneapolis, Minnesota law firm of Dorsey & Whitney, learned that his firm's client, Grand Met PLC ("Grand Met"), was contemplating a takeover of Minneapolis-based

¹⁰² *Carpenter*, 791 F.2d at 1034 (emphasis added).

¹⁰³ The significance of *Carpenter*'s dicta was not lost, however, on the district court in *SEC v. Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986), which cited *Carpenter*'s acknowledgement of a misappropriator's corollary duty to marketplace traders but concluded that, in this case, it "need go no further than enforcement of the duty not to trade without disclosure to the beneficiary of the fiduciary relationship." *Id.* at 621 n.47.

¹⁰⁴ 117 S. Ct. 2199 (1997).

¹⁰⁵ In addition to the antifraud prohibitions in Section 10(b) and Rule 10b-5, trading while in possession of material, nonpublic information in connection with a tender offer may trigger liability under Exchange Act Section 14(e), 15 U.S.C. § 78n(e) (1994), and SEC Rule 14e-3, 17 C.F.R. § 240.14e-3 (1997), promulgated thereunder. Specifically, Rule 14e-3 prohibits trading by any person in possession of material, nonpublic information relating to a tender offer when that person knows or has reason to know that the information is nonpublic and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. *See id.* Although the validity of Rule 14e-3 was also at issue in *O'Hagan*, this Article limits its focus to the analysis of the misappropriation theory of insider trading liability under Section 10(b) and Rule 10b-5. Consequently, it discusses neither the development of Rule 14e-3 nor the Court's decision in *O'Hagan* to reinstate O'Hagan's convictions that were premised on Rule 14e-3's validity.

Pillsbury Company ("Pillsbury").¹⁰⁶ The following month, and on other occasions throughout that summer, O'Hagan purchased call options for Pillsbury stock as well as shares of common stock. In October 1988, Grand Met announced a public tender offer for Pillsbury, and the stock immediately rose from \$39 per share to almost \$60 per share. When he exercised his Pillsbury options and subsequently liquidated the stock, O'Hagan realized a profit of over \$4.3 million. He was charged with securities fraud (in violation of the Securities Exchange Act of 1934, Section 10(b) and Section 14(e),¹⁰⁷ and Rules 10b-5 and 14e-3¹⁰⁸ promulgated thereunder) and with federal mail fraud.¹⁰⁹ A jury convicted him on all of the counts, and he was sentenced to forty-one months of imprisonment.¹¹⁰

The Government premised its Section 10(b) and Rule 10b-5 case on a misappropriation theory because neither O'Hagan nor his law firm had any relationship with, or owed any duty to, the shareholders of Pillsbury.¹¹¹ On appeal, a divided panel of the Eighth Circuit rejected the validity of that theory and reversed O'Hagan's convictions for violating Section 10(b) and Rule 10b-5.¹¹² The Eighth Circuit articulated two reasons in support of its conclusion that Section 10(b) and Rule 10b-5 liability cannot be based on the misappropriation theory. First, the court found that contrary to Section 10(b)'s explicit requirements, "the misappropriation theory does not require 'deception.'"¹¹³ And second, even assuming that Section 10(b)'s deception element is satisfied, the court found the theory "renders nugatory the requirement that the 'deception' be 'in connection with the purchase or sale of any security.'"¹¹⁴

B. *Views of the Majority*

The *O'Hagan* majority concluded that both of the Eighth Circuit's holdings regarding the misappropriation theory were in error. In so doing, it reversed an

¹⁰⁶ *O'Hagan*, 117 S. Ct. at 2205.

¹⁰⁷ 15 U.S.C. §§ 78j(b), 78n(e) (1994).

¹⁰⁸ 17 C.F.R. §§ 240.10b-5, 240.14e-3 (1997).

¹⁰⁹ 18 U.S.C. § 1341 (1994).

¹¹⁰ *See O'Hagan*, 117 S. Ct. at 2205.

¹¹¹ *See id.* at 2208 n.5.

¹¹² *See United States v. O'Hagan*, 92 F.3d 612, 622 (8th Cir. 1996). The Eighth Circuit also reversed O'Hagan's convictions under Section 14(e) and Rule 14e-3, and under the federal mail fraud statute. *See id.* at 627-28.

¹¹³ *Id.* at 617. The court noted that Section 10(b) also proscribes the use of manipulative devices, but concluded that manipulation is a term of art that did not in any way encompass O'Hagan's conduct. *See id.* at 615 n.4.

¹¹⁴ *Id.* at 617.

unmistakable trend in two decades of Supreme Court opinions that had narrowly construed the text of the federal securities laws in general, and Section 10(b) in particular.¹¹⁵

At the outset of its analysis, the majority clearly articulated the definition of the misappropriation theory that it was measuring against the statutory text: "The 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."¹¹⁶ While the Court acknowledged the broader reading of the theory advocated by Chief Justice Burger and other members of the *Chiarella* Court, the Court noted that the Government did "not propose that we adopt a misappropriation theory of that breadth."¹¹⁷ Accordingly, the Court premised misappropriation liability solely on a "fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."¹¹⁸

The Court then elaborated on why a misappropriator's conduct satisfies the "deception" element that is necessary to state a claim for liability under Section 10(b) and Rule 10b-5. Quoting substantially from the Government's brief, the Court maintained that "misappropriators . . . deal in deception . . . [by pretending] 'loyalty to the principal while secretly converting the principal's information for personal gain.'"¹¹⁹ Thus, the misappropriator "'dupes' or

¹¹⁵ See, e.g., *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (no implied private right of action for aiding and abetting liability under Section 10(b) and Rule 10b-5); *Dirks v. SEC*, 463 U.S. 646 (1983) (tippee of a traditional insider violates Section 10(b) and Rule 10b-5 under the classical theory only when the insider-tipper acts for a personal benefit); *Chiarella v. United States*, 445 U.S. 222 (1980) (securities trader, under the classical theory, violates Section 10(b) and Rule 10b-5 only when a relationship of trust and confidence exists with the parties with whom she is trading); *Sante Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) (breach of fiduciary duty not involving deception or manipulation is not unlawful under Section 10(b) and Rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (liability under Section 10(b) and Rule 10b-5 does not extend to conduct that is merely negligent—only intentional misconduct is proscribed); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (standing to bring an implied private right of action under Section 10(b) and Rule 10b-5 is limited to actual purchasers or sellers of securities).

¹¹⁶ *O'Hagan*, 117 S. Ct. at 2207.

¹¹⁷ *Id.* at 2208–09 n.6. The Court's reference to Chief Justice Burger's misappropriation theory may have been prompted by arguments by *amici* supporting the validity of that broader theory. See NASAA Brief, *supra* note 16, at 11–14 (maintaining that "Chief Justice Burger's disclosure-based misappropriation theory of liability is a sound and sensible application of Section 10(b) and Rule 10b-5, and it satisfies the statutory requirements of a deception and a connection to the purchase or sale of securities").

¹¹⁸ *O'Hagan*, 117 S. Ct. at 2207.

¹¹⁹ *Id.* at 2208 (quoting Brief for the United States at 17, *United States v. O'Hagan*, 117

'defrauds' the principal."¹²⁰ The Court also harmonized its view of the "deception" element with its holding in *Santa Fe Industries, Inc. v. Green*¹²¹ that Section 10(b) should not be read as proscribing every breach of fiduciary duty connected to a securities transaction. According to the Court, the critical difference was that, in contrast to the Government's allegations against O'Hagan, in *Santa Fe* the defendants had disclosed all facts that were pertinent to the disputed transaction. The Court therefore emphasized that full disclosure to the source of the information of the fiduciary's intent to trade would foreclose liability under the misappropriation theory.¹²²

The Court turned next to Section 10(b)'s requirement that the misappropriator's deceptive use of misappropriated information must be "in connection with the purchase or sale of [a] security."¹²³ The Court maintained that this element was satisfied "because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities."¹²⁴ Thus, liability under Section 10(b) is triggered because the deception and the securities transaction necessarily coincide. The Court further acknowledged that the misappropriation theory does not extend to all conceivable forms of fraud and deception involving confidential information; "rather, it catches fraudulent means of capitalizing on such information through securities transactions."¹²⁵ The Court also stressed that Section 10(b)'s language requires only deception "in connection with the purchase or sale of any security" and does not specify deception of an identifiable purchaser or seller.¹²⁶ Thus, the Court held that the Eighth Circuit's conclusion that "[o]nly a breach of a duty to the parties to the securities transaction . . . or, at most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability"

S. Ct. 2199 (1997) (No. 96-842)).

¹²⁰ *Id.*

¹²¹ 430 U.S. 462 (1977).

¹²² *See O'Hagan*, 117 S. Ct. at 2208. The Court did note, however, that where a person trading on the basis of material, nonpublic information owes pre-existing duties of loyalty and confidentiality to multiple entities or persons, disclosure only to one entity or person is not enough to foreclose liability under Section 10(b)—full disclosure must be made to each entity or person to whom the trader owes a duty. *See id.* at 2209 n.7.

¹²³ *Id.* at 2209.

¹²⁴ *Id.*

¹²⁵ *Id.* Here, the majority was mindful to note that the Government somewhat overstated its case in contending (in briefs and in oral argument) that confidential information of the kind possessed by O'Hagan derives its value *only* from its utility in securities trading. Yet the Court concluded that "[s]ubstitut[ing] 'ordinarily' for 'only,'" brought the Government back "on the mark." *Id.* at 2210.

¹²⁶ *See Id.*

was clearly in error.¹²⁷

Finally, the Court justified its reading of the statutory text by highlighting the policy behind the Exchange Act: “to insure honest securities markets and thereby promote investor confidence.”¹²⁸ It made “scant sense” to the Court “to hold a lawyer like O’Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder.”¹²⁹ It is here that the *O’Hagan* majority came closest to validating a more expansive version of the misappropriation theory that would have included investors among the parties defrauded by the misappropriator’s trading.¹³⁰ Yet the majority was able to disentangle the possibly serious harms to third party investors from the deception that gave rise to the misappropriator’s Section 10(b) and Rule 10b-5 liability. That is, while acknowledging that trading on the basis of misappropriated information may perpetuate injury on at least two identifiable parties—the source of the information and the investors on the other side of the misappropriator’s transaction—the Court recognized only the source of the information as the party actually deceived within the meaning of Section 10(b).¹³¹

C. Views of the Dissenting Justices

The three dissenting members of the Court disagreed not with the majority’s contention that the undisclosed misappropriation of confidential information by a fiduciary can constitute a “deceptive device” within the meaning of Section 10(b), but rather with the majority’s conclusion that such deception is used or employed “in connection with the purchase or sale” of securities.¹³² Justice

¹²⁷ *Id.* at 2211 (quoting *United States v. O’Hagan*, 92 F.3d 612, 618 (8th Cir. 1996)).

¹²⁸ *O’Hagan*, 117 S. Ct. at 2210.

¹²⁹ *Id.* at 2210–11.

¹³⁰ *See infra* text and accompanying notes 385–92 (contending that *O’Hagan* left the validity of a broader misappropriation theory unresolved).

¹³¹ *See O’Hagan*, 117 S. Ct. at 2209 (noting that “the deception essential to the misappropriation theory involves feigning fidelity to the source of the information . . .”).

¹³² *See Id.* at 2220 (Scalia, J., concurring in part and dissenting in part), 2220–21 (Thomas, J., and Rehnquist, C.J., concurring in the judgment in part and dissenting in part). Justice Scalia dissented only from the Court’s holding with respect to O’Hagan’s liability under Section 10(b) and Rule 10b-5, and concurred with the majority’s decision to reinstate O’Hagan’s convictions under Section 14(e) and Rule 14e-3 and under the federal mail fraud statute. *See id.* at 2220 (Scalia, J., concurring in part and dissenting in part). Justice Thomas and Chief Justice Rehnquist dissented from both of the Court’s holdings under the federal securities laws and concurred only in the Court’s judgment with respect to reinstating O’Hagan’s convictions under the federal mail fraud statute. *See id.* at 2220–21 (Thomas, J., and Rehnquist, C.J., concurring in the judgment in part and dissenting in part).

Scalia issued a brief opinion emphasizing that, in light of the rule of lenity applied to criminal statutes,¹³³ the unelaborated statutory “in connection with” language “must be construed to require the manipulation or deception of a party to a securities transaction.”¹³⁴ This conclusion by Justice Scalia was essentially echoed in a more lengthy opinion by Justice Thomas, which was joined by Chief Justice Rehnquist. In that opinion, Justice Thomas sharply criticized both the majority and the SEC for their failure “to provide a coherent and consistent interpretation of this essential requirement for liability under § 10(b).”¹³⁵

Justice Thomas appeared particularly troubled by the failure of both the SEC and the majority to offer a satisfactory explanation as to why the fraudulent theft of information for the purpose of purchasing securities falls within the misappropriation theory, while the fraudulent theft of money for the purpose of purchasing securities does not.¹³⁶ The majority’s explanation—that the “fraud” involving the misappropriation of the information is consummated when the securities trading occurs, whereas “fraud” involving the theft of tangible property occurs immediately—was dismissed as unsatisfying.¹³⁷ According to Justice Thomas, misappropriated information could be used for many purposes other than securities trading. It could, for example, be sold to newspapers.¹³⁸ Thus, just as trading in securities using stolen money was too attenuated to satisfy the “in connection with” requirement, so too, in his view, was trading in securities using stolen information.¹³⁹ Emphasizing that “it is the use of fraud ‘in connection

¹³³ The “rule of lenity” provides that any ambiguity in criminal statutes must be strictly construed. *See, e.g.*, *United States v. Lanier*, 117 S. Ct. 1219, 1225 (1997); *Dowling v. United States*, 473 U.S. 207, 213–14 (1985). In this regard, the rule of lenity is said to ensure fair warning of criminal sanctions and to limit the scope of many penal statutes:

[W]hen assessing the reach of a federal criminal statute, we must pay close heed to language, legislative history, and purpose in order to strictly determine the scope of conduct the enactment forbids. Due respect for the prerogatives of Congress in defining federal crimes prompts restraint in this area, where we typically find a ‘narrow interpretation’ appropriate.

Dowling, 473 U.S. at 213–14.

¹³⁴ *O’Hagan*, 117 S. Ct. at 2220 (Scalia, J., concurring in part and dissenting in part).

¹³⁵ *Id.* at 2221 (Thomas, J., concurring in the judgment in part and dissenting in part).

¹³⁶ *See id.* (noting the majority’s approval of the Government’s contention that purchasing securities with funds that had been embezzled from a fiduciary *would not* trigger liability under Section 10(b)).

¹³⁷ *See id.* at 2223–24.

¹³⁸ *See id.* at 2223.

¹³⁹ *See id.* at 2223–24 (contending that “[i]f the relevant test under the ‘in connection with’ language is whether the fraudulent act is *necessarily* tied to a securities transaction, then

with' a securities transaction that is forbidden" under Section 10(b), Justice Thomas concluded that "[w]here the relevant element of fraud has no impact on the integrity of the subsequent transactions... one can reasonably question whether the fraud was used in connection with a securities transaction."¹⁴⁰ Accordingly, Justice Thomas and Chief Justice Rehnquist would have affirmed the Eighth Circuit's decision to overturn O'Hagan's convictions for insider trading in violation of Section 10(b) and Rule 10b-5.¹⁴¹

III. A CRITIQUE OF O'HAGAN

By reinstating O'Hagan's convictions for violating Section 10(b) and Rule 10b-5, the Court in *O'Hagan* reached the right result for a number of wrong reasons.¹⁴² Without a misappropriation theory to supplement *Chiarella's* and *Dirks's* classical theory of insider trading liability, a large variety of securities transactions involving the use of material, nonpublic information would necessarily fall outside the scope of Section 10(b) and Rule 10b-5.¹⁴³ For example, in the absence of a misappropriation theory, Section 10(b) and Rule 10b-5 would not preclude the following: transactions involving corporate

the misappropriation of confidential information used to trade no more violates § 10(b) than does the misappropriation of funds used to trade").

¹⁴⁰ *Id.* at 2226.

¹⁴¹ *See id.*

¹⁴² To be sure, some of the other commentary on *O'Hagan* has been more complimentary, even while acknowledging certain problems with the Court's reasoning. *See, e.g.,* Brudney, *supra* note 24; Pritchard, *supra* note 70; Joel Seligman, *A Mature Synthesis: O'Hagan Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1 (1998); Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395 (1998). Other commentary has been, perhaps, even more critical. *See, e.g.,* Roberta S. Karmel, *Outsider Trading On Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83 (1998); Kimberly D. Krawiec, *Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing United States v. O'Hagan*, 33 TULSA L.J. 163 (1997); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157 (1997).

¹⁴³ *See* John F. Olson et al., *Reporting of the ABA Task Force on the Regulation of Insider Trading*, 41 BUS. LAW 223, 237 (1985) (stating that misappropriation theory fills regulatory gaps left open by strict analysis in *Chiarella* and *Dirks*); *see also* Brief for United States, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), available in 1997 WL 86306 at *16 n.8 (describing the misappropriation theory as a "cornerstone in the SEC's efforts to combat the deceptive misuse of confidential information in the nation's securities markets" and noting that the "theory has been used in the past 15 years in scores of civil and criminal cases, including some of the most significant securities fraud cases of that period").

insiders or temporary insiders of one company who use material, nonpublic information to purchase securities in another company;¹⁴⁴ transactions by employees who use confidential business information in the course of trading securities in companies other than their employers;¹⁴⁵ transactions by government officials who purchase securities based on confidential information that they learn in the course of their public service;¹⁴⁶ and (possibly) transactions by officers, directors, and other permanent or temporary insiders who use material, nonpublic information to purchase debt securities issued by their own corporation.¹⁴⁷ Because all of these transactions involve conduct that significantly undermines the integrity of, and investor confidence in, securities

¹⁴⁴ See *supra* text accompanying notes 9–12 (discussing a hypothetical GM director who trades Ford stock on the basis of information learned at a board meeting). The facts of *O'Hagan* as well as *Chiarella* also fit this scenario of outsider trading. Because both *O'Hagan* and *Chiarella* involved temporary insiders of an acquiring company who purchased a target's securities on the basis of material, nonpublic information concerning a tender offer, Rule 14e-3 would provide the Government with an alternative avenue for prosecution. See 17 C.F.R. § 240.14e-3; see *supra* note 105. However, in cases where securities are purchased in a company to be acquired by means other than a tender offer, Section 10(b) and Rule 10b-5 would constitute the only provisions under the federal securities laws that would proscribe such purchases by an outsider of the acquired company.

¹⁴⁵ The *Wall Street Journal* reporter and his tippees who traded securities based on upcoming favorable press provide an example of this type of outsider trading. See *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987).

¹⁴⁶ In *Chiarella*, Chief Justice Burger cited the example of a hypothetical judge's law clerk who trades on information in an unpublished opinion. See *Chiarella v. United States*, 445 U.S. 222, 242 n.3 (1980) (Burger, C.J., dissenting). The state lottery commissioner in *Bryan* who purchased securities in companies to be awarded lucrative government contracts provides an actual example. See *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995).

¹⁴⁷ Securities law scholars are not in agreement as to whether the classical theory of insider trading would extend liability under Section 10(b) and Rule 10b-5 to a corporate insider who purchases publicly traded debt, as opposed to equity, securities in the corporation. The point of contention involves the fact that, traditionally, corporate executives have not owed state law fiduciary obligations to holders of the company's debt. Compare LANGEVOORT, *supra* note 18, at 3-21 ("The approach more consistent with *Chiarella* is that no abstain or disclose obligation arises in connection with trading in debt securities, leaving liability in such a case to rest on the misappropriation theory . . ."), with Aldave, *A General Theory*, *supra* note 18, at 110 ("The reasoning of [*Chiarella* and *Dirks*] should bar insider trading in debt as well as equity securities, since it is arguable that the holders of debt securities are among the classes of persons to whom insiders owe fiduciary duties."). Although the SEC contends that there are valid arguments for liability under the classical theory, the SEC typically invokes the misappropriation theory when it institutes Section 10(b) and Rule 10b-5 actions against insiders who purchase debt securities in their companies while in possession of material, nonpublic information. See WANG & STEINBERG, *supra* note 18, at 326 (citing cases).

markets,¹⁴⁸ the public policy behind the federal securities laws would support the imposition of liability.¹⁴⁹ With this investor protection rationale clearly in mind, the *O'Hagan* Court admirably declined the opportunity to construe the text of Section 10(b) and Rule 10b-5 in the narrow manner urged by the defendant (and indeed, the dissenting Justices). This reversed a trend of defense victories, and Government losses, in Section 10(b) cases over the last two decades.¹⁵⁰

Although *O'Hagan* produced an admirable result, the route the Court took to get there is highly problematic for three separate, though somewhat related, reasons. First, *O'Hagan* endorsed an unnecessarily restrictive misappropriation theory that will likely frustrate the Government's ability in the future to pursue other, more factually complex, instances of securities trading based on misappropriated information. Second, the policy rationale used by the Court to justify the imposition of liability under Section 10(b) and Rule 10b-5 for a fraud on the source is misleading and leaves the Court vulnerable to the charge that the misappropriation theory is only a pretext for enforcing the parity of information theory that was rejected in *Chiarella* and *Dirks*. Finally, *O'Hagan's* identification of the source of the information as the actual victim of a misappropriator's fraud is very difficult to reconcile with judicial and congressional determinations regarding standing in private actions based on violations of Section 10(b) and Rule 10b-5. This Part explores each of these three fundamental problems.

A. *The Restrictive Scope of O'Hagan's Misappropriation Theory*

Commenting on the Government's victory in *O'Hagan*, a former SEC General Counsel noted that "[the case] was about as good a factual setting as you could hope for."¹⁵¹ Of course, the validity of this statement entirely depends on the result for which one hoped. Although the egregious conduct at issue may well have been ideal for sustaining *O'Hagan's* convictions for securities fraud under Section 10(b) and Rule 10b-5, the nature of *O'Hagan's*

¹⁴⁸ For a discussion of investor protection and market integrity policy considerations for prohibiting persons from trading securities on the basis of misappropriated information, see *infra* notes 220–28 and accompanying text.

¹⁴⁹ See *infra* notes 344–52 and accompanying text (discussing congressional intent behind federal securities regulation).

¹⁵⁰ See *supra* note 115 (citing cases).

¹⁵¹ Dominic Bencivenga, *The Right Set of Facts: 'O'Hagan' Court Affirms SEC Rule-Making Power*, N.Y. L.J., July 3, 1997, at 5 (col. 2) (quoting SEC former General Counsel Simon M. Lome); see also HAROLD S. BLOOMENTHAL, *SECURITIES LAW HANDBOOK* 1183 (1998) (observing that "[t]he SEC and the Government could not have had a better set of facts on which to have the misappropriation theory resolved . . .").

particular misappropriation scheme presented the Court with a rather unimaginative scenario around which to frame a theory. As such, the purportedly “good” facts were probably not so good, for they seem to have prompted a majority opinion with reasoning that is far too restrictive to accommodate many future insider trading cases involving more “sophisticated” scenarios, such as conduct involving outright theft of information by a non-fiduciary, conduct involving a fiduciary’s nondeceptive securities trading, and (possibly) conduct involving a fiduciary who tips misappropriated information. *O’Hagan’s* restrictiveness is all the more troubling because, as will be argued in Part IV of this Article, the statutory text would have supported an alternative interpretation of Section 10(b) and Rule 10b-5, which, in turn, would have ensured liability in these more “sophisticated” cases.¹⁵²

1. *The Non-Fiduciary Thief*

One scenario involving securities transactions based on misappropriated information that is not covered by *O’Hagan’s* misappropriation theory would surface whenever information has been misappropriated for securities trading purposes by a person who we can refer to as a “non-fiduciary thief.” Indeed, prior to *O’Hagan*, some courts considered it an open question as to whether Section 10(b) and Rule 10b-5 prohibit securities trading on the basis of material, nonpublic information that has been misappropriated from a source who did not stand in a fiduciary relationship with the misappropriator.¹⁵³ *O’Hagan’s* misappropriation theory, however, would be of little use in such situations because it is premised on the existence of a pre-existing relationship of trust and confidence between the misappropriator and the source of the information.¹⁵⁴

¹⁵² See *infra* Part IV.A–B.

¹⁵³ See *SEC v. Cherif*, 933 F.2d 403, 412 n.6 (7th Cir. 1991) (noting that although “[t]here has been some suggestion that Rule 10b-5 should apply even to ‘mere’ thieves [who trade on the basis of misappropriated information] . . . [w]e need not reach this question because of our holding that [defendant] breached a fiduciary duty owed to [the source of the information]”), *cert. denied*, 502 U.S. 1071 (1992); see also *United States v. Bryan*, 58 F.3d 933, 951 (4th Cir. 1995) (noting that the circuits endorsing the misappropriation theory would in principle “be obliged to find liability in the case of a simple theft . . . even where no fiduciary duty has been breached, for the *raison d’être* of the misappropriation theory in fact is concerned over ‘the unfairness inherent in trading on [stolen] information’”) (quoting *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting)).

¹⁵⁴ See Seligman, *supra* note 142, at 22 (observing that “[*O’Hagan’s*] misappropriation theory requires deception and breach of a duty to the source of information”); Weiss, *supra* note 142, at 430 (contending that a number of statements in *O’Hagan* “seem[] to establish dispositively that misappropriation will be held to involve a deceptive act or practice only when a fiduciary has traded on the basis of confidential information without first informing his

Consider the case of a computer hacker who unlawfully gains access to a corporation's internal network and subsequently manages to uncover confidential information revealing that the company is set to announce an exciting break-through in technology that is sure to send its stock price soaring. Assuming that he has no pre-existing relationship with the corporation, any pre-announcement stock purchases by the computer hacker would escape Section 10(b) and Rule 10b-5 liability under *O'Hagan's* "fraud on the source" misappropriation theory. This is because, in the words of *O'Hagan*, "the misappropriation theory premises liability on a fiduciary-turned trader's deception of those who entrusted him with access to confidential information."¹⁵⁵ Because the computer hacker was not entrusted with such access, Section 10(b) and Rule 10b-5 would not be violated under *O'Hagan's* theory, even though the computer hacker would be trading securities on the basis of material, nonpublic information that had been misappropriated.¹⁵⁶

The result would be the same in a case involving a less technologically sophisticated non-fiduciary thief who misappropriates information the old fashioned way—by breaking into a locked corporate office and stealing the confidential information. Although such a person may be guilty of burglary and theft, *O'Hagan's* theory would not hold subsequent securities trading by this thief a violation of Section 10(b) and Rule 10b-5.¹⁵⁷ Moreover, even if the thief

beneficiary that he intends to trade"). *But see infra* text accompanying notes 161–65 (questioning whether *O'Hagan* leaves open the possibility of a broader "fraud on the source" misappropriation theory that would establish Section 10(b) and Rule 10b-5 liability in cases where a non-fiduciary uses deceptive acts or practices to misappropriate information for securities trading purposes).

¹⁵⁵ *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997); *see also id.* at 2209 (emphasizing that "the deception essential to the misappropriation theory involves feigning fidelity to the source of the information").

¹⁵⁶ Breaking into a company's confidential computer database and using the company's information for *any* personal purpose would likely constitute the misappropriation of a trade secret, actionable in private civil suits and potentially triggering criminal liability under federal and state laws. *See, e.g.*, Unif. Trade Secrets Act of 1996, 14 U.L.A. 433 (Supp. 1998) (adopted in forty-one states and the District of Columbia and providing private right of action for misappropriation of a trade secret); Economic Espionage Act of 1996, Pub. L. No. 104-294 §§ 1831-1839, 110 Stat. 3488 (codified at 18 U.S.C. §§ 1831-1839) (federal criminal trade secrets statute that, despite its name, applies to anyone who knowingly engages in any act of misappropriation "with intent to convert a trade secret, . . . to the economic benefit of anyone other than the owner thereof, and intending or knowing that the offense will injure any owner of that trade secret"); MELVIN F. JAGER, TRADE SECRETS LAW, App. L-1 through App. L-43 (1996) (collecting state criminal trade secret statutes). *See generally* James H.A. Pooley et al., *Understanding the Economic Espionage Act of 1996*, 5 TEX. INTELL. PROP. L.J. 177 (1997) (discussing liability for misappropriation of trade secrets under federal and state law).

¹⁵⁷ In oral argument before the Court in *O'Hagan*, the Government explicitly

had been a former employee of the company rather than a stranger, his undisclosed securities trading would still not constitute deception under *O'Hagan*. Unlike a current employee such as O'Hagan, the former employee would not have "pretend[ed] loyalty to the [source] while secretly converting the [source's] information for personal gain,"¹⁵⁸ and he would not have "feign[ed] fidelity to the source of the information" while carrying out his securities trading.¹⁵⁹ Indeed, under this scenario, the former employee would have been a "non-fiduciary" both at the time he stole the information and at the time he used the information for his personal profit in securities trading. Accordingly, *O'Hagan* would not support Section 10(b) and Rule 10b-5 liability.¹⁶⁰

acknowledged that under its version of the misappropriation theory, Section 10(b) and Rule 10b-5 are not violated if the misappropriated information was obtained through "mere" theft by a non-fiduciary. *See* Transcript of Oral Argument, *United States v. O'Hagan*, 117 S. Ct. 2199 (1998), available in 1997 WL 182584 at *5 [hereinafter Tr. of Oral Arg.]:

MR. DREEBEN: The misappropriation theory . . . involves, just as the facts did in *Carpenter v. United States*, an agent entrusted with information by a principal under the understanding between the parties that the agent would not use that information for any personal gain without obtaining the principal's agreement.

QUESTION: Well, Mr. Dreeben, then if someone stole the lawyer's briefcase and discovered the information and traded on it, no violation?

MR. DREEBEN: That's correct, Justice O'Connor.

Id.

¹⁵⁸ *O'Hagan*, 117 S. Ct. at 2208 (quoting Brief for United States, *O'Hagan*, 117 S. Ct. 2199 (1997), available in 1997 WL 86306 at *17).

¹⁵⁹ *See O'Hagan*, 117 S. Ct. at 2209.

¹⁶⁰ In *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992), the Seventh Circuit affirmed a Rule 10b-5 violation in a case involving a former bank employee who had unlawfully entered the offices of his former employer for the purpose of gaining access to confidential client information that he would later use for securities trading purposes. The Seventh Circuit viewed as irrelevant the fact that Cherif's thefts and trades were carried out "after his employment ended," *id.* at 411, concluding that "Cherif [had] breached a continuing [fiduciary] duty to his former employer." *Id.* (emphasis added). Even prior to the Court's decision in *O'Hagan*, the Seventh Circuit's holding in *Cherif* was criticized by securities law scholars who questioned how Cherif could be said to have deceived and defrauded a former employer. *See, e.g.,* Kenny & Thebaut, *supra* note 78, at 200 (bemoaning that "the Seventh Circuit [in *Cherif*] abandoned its dictionary and expanded the definition of 'fraud' in Section 10(b) to apply to the theft of information by a non-fiduciary"); LANGEVOORT, *supra* note 18, at 6-19 n.4 (stating that "[t]hough surely well intentioned, *Cherif* is awkward If a former employee did not formulate the plan to misuse the information while an employee, only doing so after the representation of loyalty ceases, then it is hard to see the implicit fraud"). *O'Hagan's* reasoning now seems to establish that Cherif's undisclosed

It is certainly possible that in future cases, even after *O'Hagan*, lower courts might be willing to broaden the "fraud on the source" misappropriation theory to extend Section 10(b) and Rule 10b-5 liability in cases where a non-fiduciary engages in affirmative acts that deceive the source into releasing confidential information.¹⁶¹ Professor Donald Langevoort, for example, hypothesizes a situation where a person tricks another into leaving a business meeting room in order to access confidential file folders left on the table.¹⁶² He contends that "[s]o long as an element of intentional deception was present in the action, the resulting trading would lead to liability under Rule 10b-5."¹⁶³ Yet, even under this broadened misappropriation theory, it is doubtful that securities trading by the computer hacker or the "mere" thief would violate Section 10(b) and Rule 10b-5, because neither scenario would involve misappropriation through acts that would constitute affirmative deception.¹⁶⁴ Moreover, even in those circumstances where affirmative acts of deception could be established, the Government must also demonstrate that such acts occurred "in connection with" a securities transaction. In light of *O'Hagan's* narrow construction of Section 10(b)'s "in connection with" element, this may be very difficult to do.¹⁶⁵ Thus, both the utility and the viability of a broadened misappropriation theory remain unclear.

What is clear is that "the" misappropriation theory, the one framed by the

securities trading did not operate as a fraud or deception on his former employer. *But see infra* note 164 (noting that, although the Seventh Circuit premised Cherif's Section 10(b) and Rule 10b-5 liability on his purported breach of a duty owed to his former employer, Cherif's scheme to gain access to the confidential information involved acts of affirmative deception, acts that could, potentially, establish the requisite element of deception under Section 10(b)).

¹⁶¹ See LANGEVOORT, *supra* note 18, at 6-40 (suggesting that the misappropriation theory may apply to "deceptive acts or practices generally in connection with a defendant's own trading, fiduciary or not"); see also Daniel A. McLaughlin, *The "In Connection With" Requirement of Rule 10b-5 as an Expectation Standard*, 26 SEC. REG. L.J. 3, 68-69 (1998) (same).

¹⁶² See LANGEVOORT, *supra* note 18, at 6-40 to 6-41.

¹⁶³ *Id.*

¹⁶⁴ As Professor Langevoort points out, a broader version of the misappropriation theory may have provided a reasoned basis for the Seventh Circuit's decision in *Cherif*, discussed at *supra* note 160, because the former bank employee was able to gain access to the bank only by lying to bank employees about his status. See *id.* at 6-19 n.4; see also McLaughlin, *supra* note 161, at 68-69 (arguing that "what Cherif did—forgery and unauthorized use of an electronic device—seems to constitute a fairly common type of fraud, and would have been equally fraudulent if Cherif had never worked for the bank but managed to get access to the premises through a clearly forged letter").

¹⁶⁵ See *infra* text accompanying notes 239-45 (questioning whether *O'Hagan's* misappropriation theory establishes Section 10(b) and Rule 10b-5 liability only when the deception of the source "coincides" with a securities transaction).

O'Hagan Court, does not provide a theory of Section 10(b) and Rule 10b-5 liability that can be utilized in cases involving securities trading based on information that was misappropriated by a non-fiduciary thief. This is troubling because *O'Hagan* expressed repeated and sincere concerns for trading that negatively affects the federal securities markets.¹⁶⁶ Yet, as will be discussed more fully below,¹⁶⁷ the impact on the market would seem to be precisely the same regardless of whether trading on misappropriated information is carried out by a current employee and fiduciary (like *O'Hagan*) or by a person who lacks any current or former relationship to the source of the confidential information (like the computer hacker or the "mere" thief).

2. *The Brazen Fiduciary*

O'Hagan's version of the misappropriation theory fails to provide a theory that would extend Section 10(b) and Rule 10b-5 liability to cases involving another category of individuals trading on stolen information: fiduciaries who disclose to their principals the fact that they intend to use confidential information in a subsequent securities transaction. Before the Court's decision in *O'Hagan*, it was well recognized that fiduciaries or other third parties could trade with impunity under Section 10(b) and Rule 10b-5 if the source of the information had authorized the use of its confidential business information in personal securities trading.¹⁶⁸ *O'Hagan* now widens this existing liability loophole to cover fiduciaries who, though they lack authorization, nonetheless disclose their trading intent to the source of the information.¹⁶⁹ As the *O'Hagan*

¹⁶⁶ See *infra* text accompanying notes 237–45.

¹⁶⁷ See *infra* text accompanying notes 251–55.

¹⁶⁸ See *O'Hagan*, 117 S. Ct. at 2225 n.5 (citing Tr. of Oral Arg., *supra* note 157, at *9 (Government attorney conceding that had the *Wall Street Journal* in *Carpenter* authorized the reporter to trade, there would have been no Section 10(b) violation because "there would have been no deception of the *Wall Street Journal*"). As the *O'Hagan* Court recognized, one of the SEC's principal reasons for promulgating Rule 14e-3 was to prevent "warehousing," which the SEC describes as "the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is announced." *O'Hagan*, 117 S. Ct. at 2217 n.17 (citing Reply Brief for the United States at 17). The Court further recognized that the SEC cannot use Rule 10b-5 to prosecute warehousing because "trading authorized by a principal breaches no fiduciary duty." *Id.*

¹⁶⁹ See the recent and aptly titled article by Painter et al., *supra* note 142, which calls attention to *O'Hagan's* irony that "[o]nce the intent to trade is disclosed to the principal, the trading is legal under Section 10(b), no matter how strenuously the principal objects." *Id.* at 180; see also Joseph McLaughlin, 'O'Hagan': *Some Answers, More Questions*, N.Y. L.J. July 1, 1997, at 1 (characterizing *O'Hagan's* "full disclosure to the source exception" as a "foul ball" in an otherwise "home run" decision and stating that "the damage [it] causes will not be

Court explained, "if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."¹⁷⁰ Let us term the individual who discloses to the source and then trades the "brazen fiduciary."

How likely is it that securities trading by brazen fiduciaries will occur? In the employment context, one can expect instances of trading by brazen fiduciaries to be few and far between. Although *O'Hagan's* misappropriation theory may foreclose liability under Section 10(b) and Rule 10b-5, brazen fiduciaries who use their employer's confidential information for personal securities trading purposes would no doubt get their comeuppance through a termination notice that likely would be followed by the initiation of a civil lawsuit by the employer sounding in breach of fiduciary duty.¹⁷¹ This is probably enough to deter most employees from taking advantage of *O'Hagan's* "full disclosure" liability loophole.

But the same conclusion probably cannot be drawn with respect to fiduciary-like relationships outside the employment context. Indeed, family members who use confidences placed in them by other family members, or professionals who use confidences placed in them by their clients, may well have less to lose by informing the source about their intent to trade securities based on those confidences. And *O'Hagan* makes clear that these brazen fiduciaries have very much to gain: full disclosure to family members or clients would seem to foreclose a finding of deception, even if they were to voice an objection to the trading.¹⁷² Thus, had the son in *United States v. Reed*¹⁷³ told his father about his personal securities trading or, for that matter, had the psychiatrist in *United States v. Willis*¹⁷⁴ informed his patient about his personal trading plans, they presumably would have been free to purchase or sell securities based on that information without any risk of liability under Section 10(b) and Rule 10b-5. Yet once again, as with trading on misappropriated information obtained by a computer hacker or a "mere" thief, the impact on the securities markets would

known for some time").

¹⁷⁰ *O'Hagan*, 117 S. Ct. at 2209.

¹⁷¹ *See id.* at 2211 n.9 (noting that "once a disloyal agent discloses [to the source] his imminent breach of duty, his principal may seek appropriate equitable relief under state law").

¹⁷² *See id.* at 2209.

¹⁷³ 601 F. Supp. 685 (S.D.N.Y.) (applying misappropriation theory against son who allegedly traded on the basis of material, nonpublic information obtained in breach of a duty owed to father, a corporate director), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

¹⁷⁴ 737 F. Supp. 269 (S.D.N.Y. 1990) (applying misappropriation theory against a psychiatrist who allegedly traded on the basis of material, nonpublic information concerning a corporate executive's activities, information that was learned in the course of treating the wife of the corporate executive).

seem to be the same regardless of whether the securities trading is carried out by a brazen fiduciary or a deceitful one.¹⁷⁵

Moreover, even in the absence of a fiduciary's disclosure of his trading intent to the source of confidential information, *O'Hagan's* liability loophole for brazen fiduciaries may have an unintended consequence in future misappropriation cases. Indeed, the opinion may encourage defendants to defend against Section 10(b) and Rule 10b-5 liability on the ground that the source of the information knew about the intended use of the misappropriated information and therefore was not deceived by such use.¹⁷⁶ This possibility is again less troubling in the context of employment relationships because few employers would support an employee's asserted defense that the employer was aware of the use of its confidential, nonpublic information.¹⁷⁷ However, the father whose son is charged under Section 10(b) and Rule 10b-5 with trading on misappropriated information, or the patient who does not wish to see her doctor in jail or subject to a civil penalty for such a violation, may well be reluctant to cooperate with the government in refuting the defendant's allegations that they knew about the defendant's personal securities trading.¹⁷⁸ Thus, after *O'Hagan*,

¹⁷⁵ See *infra* notes 251–55 and accompanying text. *O'Hagan's* speculation that a principal may seek appropriate equitable relief under state law against a brazen fiduciary, see *supra* note 171, even if realistic in the employment context, would be fanciful in the context of family or professional relationships. Can fathers be expected to file injunctive actions against sons, or patients to file injunctive actions against doctors, to ensure that their fiduciary's imminent securities trading is not carried out?

¹⁷⁶ See Christopher C. Faille, *Securities Fraud Prosecution: Drifting Into Dangerous Waters*, 44 FED. LAW., Nov.–Dec. 1997, at 24, 30 (stating that after *O'Hagan*, “[i]t is easy to imagine a series of cases, in each of which a trader, alleged to have misappropriated information, claims that the source of his information *did* know that he intended to use it to trade [securities] . . . [Courts must now] struggle to create standards for how much one has to tell one's client or principal to immunize one's self from prosecution.”).

¹⁷⁷ To be sure, company officials are also unlikely to cooperate with a brazen fiduciary's defense because doing so may jeopardize their own innocence, by triggering “controlling person” liability under Section 21A(a)(3) of the Exchange Act, 15 U.S.C. § 78u-1(a)(3) (1994). Section 21A authorizes the SEC to seek civil monetary penalties against any person who, directly or indirectly, controlled a person who has violated the Exchange Act by trading securities while in possession of material, nonpublic information if that controlling person “knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred.” 15 U.S.C. § 78u-1(b)(1)(a).

¹⁷⁸ In connection with the Rule 14e-3 issue presented in *O'Hagan*, the Court specifically acknowledged the “difficulties in proving breach of duty in ‘misappropriation’ cases [brought under Rule 10b-5].” *O'Hagan*, 117 S. Ct. at 2218 n.20. The Court hypothesized that a lawyer-father who told a child about an upcoming tender offer might “gratuitously protect” his son or daughter—a possibility that, in the Court's view, makes Rule 14e-3 an essential regulatory tool

the government may face higher hurdles in proving deception in misappropriation cases premised on the fraud that is perpetrated on the source of the information.

3. Tipper/Tippee Liability After O'Hagan

Because O'Hagan acted alone in his scheme to defraud Dorsey & Whitney and Grand Met, the Court was not asked for, nor did it render, an opinion as to whether the "fraud on the source" theory applies when securities transactions are based on a "tip" grounded in misappropriated information. Although lower courts routinely have used a "fraud on the source" misappropriation theory to impose Section 10(b) and Rule 10b-5 liability in tipper/tippee cases,¹⁷⁹ a post-*O'Hagan* question is sure to be whether such cases fall within the reasoning that was used by the Court to uphold O'Hagan's convictions.

Traditionally, the liability imposed in tipper/tippee misappropriation cases stems from the theory noted by the Court in *Chiarella* and *Dirks* as to why a corporate insider's tippee incurs liability under Section 10(b) and Rule 10b-5: under the classical theory, the tippee's obligation to abstain from trading or to disclose the material, nonpublic information to the shareholders arises from his role as a co-participant in the tipper's breach of a fiduciary duty.¹⁸⁰ Similarly, under the misappropriation theory, a tippee's liability is premised on the fact that the misappropriator (*i.e.*, the tipper) breaches a fiduciary duty to the source of the information and that, as a co-participant in that breach, the tippee inherits the misappropriator's disclosure duties to the source of the information.¹⁸¹ In other words, in "fraud on the source" cases, just like in classical insider trading cases, the tippee's Section 10(b) and Rule 10b-5 liability for nondisclosure is derivative. A misappropriator's tippee therefore can be considered a co-

for preventing fraud in tender offers because liability under Rule 14e-3 does not depend on the government's ability to *prove* the breach of a fiduciary duty. *See id.*

¹⁷⁹ *See, e.g.*, *United States v. Mylett*, 97 F.3d 663 (2d Cir. 1996) (director of acquiring company tipped friend who purchased stock in target), *cert. denied sub nom. United States v. Cusimano*, 117 S. Ct. 2509 (1997); *Carpenter v. United States*, 791 F.2d 1024 (2d Cir. 1986), *aff'd by an equally divided court*, 484 U.S. 19 (1987) (*Wall Street Journal* reporter tipped friends as to the contents of upcoming financial columns); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983) (investment bank employees illegally tipped third parties of upcoming acquisitions); *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) (staff employee of law firm tipped friends and relatives of upcoming transactions).

¹⁸⁰ *See Dirks v. SEC*, 463 U.S. 646, 659-64 (1983); *Chiarella v. United States*, 445 U.S. 222, 230 n.12 (1980); *see also supra* notes 9, 43-48 and accompanying text (discussing tipper/tippee liability under the classical theory of insider trading).

¹⁸¹ *See Mylett*, 97 F.3d at 667-68; *Carpenter*, 791 F.2d at 1032; *Newman*, 664 F.2d at 16; *Musella*, 578 F. Supp. at 434-37.

participant in the misappropriator's deceptive scheme to "feign[] fidelity to the source of the information"¹⁸² and to "pretend[] loyalty to the [source] while secretly converting the [source's] information for personal gain."¹⁸³ Even after *O'Hagan*, this analysis would seem to satisfy Section 10(b)'s "deception" requirement in tipper/tippee cases under the misappropriation theory.¹⁸⁴

But a similar conclusion cannot as easily be reached regarding Section 10(b)'s requirement that the fraud and deception occur "in connection with" the purchase or sale of a security. According to *O'Hagan*: "This element is satisfied because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide."¹⁸⁵ In other words, O'Hagan's purchases of Pillsbury can be said to have "coincided" with his breach of duty to the source because, until he traded those securities, he did nothing to deprive the law firm and the client of their "exclusive use of that information."¹⁸⁶ Thus, as recent commentators have stated succinctly, O'Hagan's misappropriation was "connected to the securities trade *because it [was] the act of trading securities.*"¹⁸⁷

O'Hagan's rather tight construction of the "in connection with" requirement may well have been necessary to demonstrate the requisite nexus between the fraud on the source and the securities transaction, a nexus that is a precondition to liability under Section 10(b) and Rule 10b-5. Unfortunately, this exacting nexus fails to embrace most cases involving securities trading on a misappropriated tip. Unlike when the misappropriator is acting alone, in most tipper/tippee insider trading cases, the misappropriator's undisclosed breach of

¹⁸² *O'Hagan*, 117 S. Ct. at 2209.

¹⁸³ *Id.* at 2208.

¹⁸⁴ *But see* Weiss, *supra* note 142, at 437 (anticipating potential difficulties in misappropriation cases involving tippee trading because, to satisfy Section 10(b)'s deception element, "[t]he government would need to prove that the tippee knew or should have known that [the tipper] acted without the consent of his principal or did not inform his principal of his intent to tip"). Professor Weiss contends that "[s]uch evidence would seem to be required if the tipper's only deceptive act was his failure to disclose his intent to tip." *Id.* at 439 n.305.

¹⁸⁵ *O'Hagan*, 117 S. Ct. at 2209.

¹⁸⁶ *Id.* at 2207. The Court in *O'Hagan* noted that the Government relied on a conversation between O'Hagan and the Dorsey & Whitney partner heading the law firm's Grand Met representation to establish that O'Hagan traded on the basis of nonpublic information that had been misappropriated. *See O'Hagan*, 117 S. Ct. at 2205 n.1. Certainly there was nothing improper, let alone unlawful, about one partner questioning another about law firm business. O'Hagan engaged in unlawful misappropriation only when he *used* that confidential information for his personal benefit. *See id.* at 2209.

¹⁸⁷ Painter et al., *supra* note 142, at 185 (emphasis added).

fiduciary duty will not “coincide” with a securities transaction. Instead, the undisclosed breach of duty will occur *before* any securities transaction takes place—at the very moment when confidential information is conveyed to a tippee by the fiduciary for a personal benefit. Accordingly, it is the misappropriator’s tip that deprives the source of its “exclusive use of the information.”¹⁸⁸ Moreover, because the tippee is a co-participant in the tipper’s undisclosed misappropriation, the tippee’s deception can also be said to “coincide” with the tip, rather than with the securities transaction presumably planned at a later date. Under this analysis, trading on “tipped” information begins to look a lot like securities trading with stolen money, an activity which the Government (and apparently the Court) readily concedes is beyond the scope of Section 10(b) and Rule 10b-5.¹⁸⁹ In both cases, “the fraud [on the source] would be complete as soon as the [stolen product] was obtained.”¹⁹⁰

The Court’s focus on the fact that O’Hagan’s breach of duty “coincided” with his securities transactions calls into question convictions obtained in a number of high profile tipper/tippee cases that were premised on the “fraud on

¹⁸⁸ Justice Thomas made this important point in his dissent. *See O’Hagan*, 117 S. Ct. at 2223 n.2 (Thomas, J., concurring in the judgment in part and dissenting in part) (noting, that if O’Hagan had tipped someone else who used the information to trade, “the misappropriation would have been complete before the trade and there should be no § 10(b) liability”).

¹⁸⁹ *See id.* at 2209.

¹⁹⁰ *Id.*; *see also id.* at 2224 n.2 (Thomas, J., concurring in the judgment in part and dissenting in part) (emphasizing that “[t]he mere act of passing the information along [to a tippee] would have violated O’Hagan’s fiduciary duty and, if undisclosed, would be an ‘embezzlement’ of the confidential information, regardless of whether the tippee later traded on the information”). Here, a useful analogy can be drawn from prosecutions for corporate bribery under the federal mail fraud or wire fraud statutes codified at 18 U.S.C. §§ 1341, 1343 (1994). *See, e.g., United States v. Kent*, 608 F.2d 542 (5th Cir. 1979); *Abbott v. United States*, 239 F.2d 310 (5th Cir. 1956); *United States v. Proctor & Gamble Co.*, 47 F. Supp. 676 (D. Mass. 1942). As the Court in *Proctor & Gamble* made clear:

The normal relationship of employer and employee implies that the employee will be loyal and honest in all his actions with or on behalf of his employer, and that he will not wrongfully divulge to others the confidential information, trade secrets, etc., belonging to his employer. When one tampers with that relationship for the purpose of causing the employer to breach his duty he in effect is defrauding the employer of a lawful right. *The actual deception that is practiced is in the continued representation of the employee to the employer that he is honest and loyal to the employer’s interests.*

Id. at 678 (emphasis added and citations omitted). The fact that the purpose of the bribery is to obtain information to facilitate risk-free trading should not change the analysis that the deception of the source occurs before (perhaps long before) a securities transaction ever takes place.

the source” misappropriation theory.¹⁹¹ The facts of *United States v. Libera*,¹⁹² for instance, provide useful insight into potential problems that the Government may encounter with respect to satisfying the “in connection with” element of post-*O’Hagan* tipper/tippee cases brought under the misappropriation theory.

In *Libera*, the Government demonstrated at trial that the tippee-defendants had traded securities based on information contained in advance copies of *Business Week’s* “Inside Wall Street” column, which routinely listed “hot stocks.”¹⁹³ Key to their successful conviction under Section 10(b) and Rule 10b-5 was the fact that defendants obtained this information by paying two employees of R.R. Donnelley & Sons, the printers for *Business Week*, \$20 (later \$30) for pre-publication copies of the magazine.¹⁹⁴ The employees and their tippees, who had traded based on information in the columns, were found to have been co-participants in the fraud and deception that was perpetrated on the information’s source.¹⁹⁵

O’Hagan’s analysis of Section 10(b)’s “in connection with” element now prompts us to ask when, exactly, did this fraud on the source occur? A careful review of *Libera’s* facts would indicate that the employees breached their fiduciary duty to R.R. Donnelley and *Business Week* at the “Monkey Farm Café,” the coffee shop where the employees accepted money in return for the magazine.¹⁹⁶ The employees’ deception commenced when, upon returning to work at the printers, these fiduciaries “feigned fidelity” to their employer even

¹⁹¹ See cases cited in *supra* note 179. *O’Hagan’s* analysis of Section 10(b)’s “in connection with” element in “fraud on the source” misappropriation cases should not affect the Court’s prior holdings in *Chiarella* and *Dirks* that an insider’s tippee violates Section 10(b) and Rule 10b-5 when the tippee trades while in possession of material, nonpublic information that he knows was obtained from the insider in a manner that breached the insider’s fiduciary duty to the shareholders of the corporation. See *supra* notes 9, 43–48 and accompanying text. Under both the classical theory and the misappropriation theory, the tippee inherits the tipper’s duty to abstain or disclose. See *id.* However, under the classical theory, the tippee’s deception—his fraudulent failure to disclose—is necessarily “in connection with” a securities transaction because the disclosure duty is owed to the parties with whom the tippee is trading. See *id.* In other words, the deception that violates Section 10(b) and Rule 10b-5 under the classical theory does not “coincide” with the tip. Instead, it occurs only when the tippee fails to abstain and trades securities in violation of his (derivative) fiduciary duty to disclose material facts to the shareholders. The source of the information (the company and its shareholders) are no doubt deceived by the tippee at an earlier point in time, but that deception is the gravamen of a complaint based on the misappropriation theory—not on the classical theory.

¹⁹² 989 F.2d 596 (2d Cir.), *cert. denied sub nom.* Sablone v. United States, 510 U.S. 976 (1993).

¹⁹³ See *id.* at 598–99.

¹⁹⁴ See *id.* at 599.

¹⁹⁵ See *id.* at 597–99.

¹⁹⁶ See *id.* at 598.

though they had stolen and sold their employer's property for personal profit.¹⁹⁷ And we know that the fraud and deception "coincided" with the misappropriation, rather than with any securities transactions, because, had the purchasers of the magazine gotten cold feet and abandoned their plan to acquire the "hot stocks" listed in the column, R.R. Donnelley and *Business Week* could still claim to have been "duped" and defrauded by their disloyal employees as well as by the individuals who had bought the magazine's property.¹⁹⁸ Accordingly, because the breach of duty was "consummated" as soon as the tipped information was conveyed, the fraud on the source and the subsequent securities transaction arguably lack the requisite "in connection with" nexus for liability to be imposed under Section 10(b) and Rule 10b-5.¹⁹⁹

In future tipper/tippee liability cases brought under the "fraud on the source" misappropriation theory, some lower courts may well de-emphasize *O'Hagan's* particular construction of Section 10(b)'s "in connection with" element and stress instead the Court's observation that, unlike stolen money, misappropriated information "ordinarily" has value only in securities trading.²⁰⁰ This would

¹⁹⁷ See *O'Hagan*, 117 S. Ct. at 2209 (emphasizing that "the deception essential to the misappropriation theory involves feigning fidelity to the source of the information"), 2208 (contending that "[a] fiduciary who pretends loyalty to the principal while secretly converting the principal's information for personal gain 'dupes' or defrauds the principal").

¹⁹⁸ See *supra* note 190 (discussing prohibitions for corporate bribery under federal mail and wire fraud statutes).

¹⁹⁹ The specific question appealed to the Second Circuit in *Libera* involved whether the Government had to prove that the defendants' tippers specifically knew that their breach of duty to Donnelley and *Business Week* would lead to securities trading on that misappropriated information. See *Libera*, 989 F.2d at 597. The court concluded that this element was not required by its prior cases and declined to add it to this case. Instead, it maintained that the misappropriation theory requires only two elements "(i) a breach by the tipper of a duty owed to the owner of nonpublic information, and (ii) the tippee's knowledge that the tipper had breached the duty." *Id.* at 600. This aspect of *Libera's* holding certainly must be reevaluated in light of *O'Hagan*. If the tippers did not have any knowledge that the information conveyed would be used by the tippees for securities trading purposes, it is difficult to see how the tippers' breach of duty (in which the tippees are co-participants) can satisfy even the broadest interpretation of Section 10(b)'s "in connection with" nexus. And without a breach of duty on the part of the tipper "in connection with" a securities transaction, there is simply no basis for imposing Section 10(b) and Rule 10b-5 liability on either the tippers or the tippees.

²⁰⁰ See *O'Hagan*, 117 S. Ct. at 2210; see also *supra* note 125 (discussing the majority's substitution of the word "ordinarily" for the Government's exaggerated word "only"). In this regard, even the Court's substituted term "ordinarily" may be considered an exaggeration. Government officials routinely prosecute, and obtain convictions, in cases where defendants have used misappropriated nonpublic information to reap substantial profits in non-securities related ventures, such as cases involving purchases of real estate or cases involving commercial trade secrets. See *supra* note 156 (discussing federal prohibitions against the theft of trade secrets) and *infra* note 321 (discussing cases involving convictions under federal statutes for

allow the Government to argue that, in tipper/tippee cases, the deceptive scheme is not complete until the tippee's securities transaction takes place.²⁰¹ Focusing on the "ordinary" use of misappropriated information would also allow a court to view tipping as a co-venture or conspiracy between the fiduciary and the tippee, such that the tip and the subsequent trading could be considered a single scheme that occurred "in connection with" the purchase or sale of securities. But many courts, particularly those judges who agree with the arguments posited by *O'Hagan's* dissenting Justices, may well follow *O'Hagan's* lead by narrowly construing Section 10(b)'s "in connection with" language as a requirement that the securities transactions themselves must constitute the act of misappropriation.²⁰² Accordingly, *O'Hagan's* version of the misappropriation theory may create a substantial roadblock in future "fraud on the source" cases where the misappropriator stands as the tipper rather than the trader.

B. The Rationale Behind the "Fraud on the Source" Theory: And the Search Continues . . .

The foregoing analysis focused on *O'Hagan's* weakness from a doctrinal perspective and criticized the decision based on the likelihood that it will frustrate the prosecution of insider trading under Section 10(b) and Rule 10b-5 in cases that are more "sophisticated" than the particular scheme before the Court in *O'Hagan*. But the fact that many instances of trading on misappropriated information may escape liability under *O'Hagan's* version of the misappropriation theory also evidences an analytical weakness with the theory itself. By premising the Section 10(b) and Rule 10b-5 violation entirely on whether the source of the information was deceived and defrauded by a misappropriator's trading, the "fraud on the source" theory necessarily regards a misappropriator's conduct *vis-à-vis* the securities marketplace as legally irrelevant to the textual question of whether a "deceptive device" was used "in connection with" a securities transaction.

As the following subsections will demonstrate, the ultimate irony in

mail and wire fraud where defendants used misappropriated information to acquire real estate at a bargain price).

²⁰¹ Yet even under an argument that centers around the "ordinary" value of misappropriated information, it is generally difficult to see how the source of the information can be considered any more deceived or defrauded by a tippee's trading on information that was misappropriated by the source's fiduciary. As noted above, *see supra* text accompanying notes 188–99, the source loses its exclusive property rights to the information at the time of the tip and, except in those cases where the source has a financial interest in the underlying securities, *see infra* note 283, the source presumably would be no worse off because of the tippee's subsequent trading.

²⁰² *See supra* note 187 and accompanying text.

O'Hagan is that while the decision regards a misappropriator's effect on the securities marketplace as irrelevant to whether the source was defrauded within the meaning of Section 10(b) and Rule 10b-5, the misappropriator's effect on the securities marketplace is precisely what the Court uses as its policy justification for sustaining liability under these provisions. The result is a misappropriation theory that is far too narrow to achieve the investor protection and market integrity goals that it purports to serve, while at the same time far too broad to fit within prior Supreme Court precedents establishing when unfairness to investors can be proscribed under Section 10(b) and Rule 10b-5. Thus, in addition to its doctrinal shortcomings, *O'Hagan* can be criticized because the "fraud on the source" misappropriation theory continues to stand, in the words of one commentator, as "a theory in search of a rationalization."²⁰³

1. *Pre-O'Hagan Rationales for the Misappropriation Theory*

Since its first endorsement by the Second Circuit in the 1981 case of *United States v. Neuman*,²⁰⁴ the "fraud on the source" version of the misappropriation theory has generally been supported by one of two principal rationales: protecting the source's property rights to confidential information, or ensuring that securities markets operate—and are perceived by investors to be operating—fairly and honestly.

a. *The Property Rights Rationale*

The first court to impose liability under the misappropriation theory apparently did so to protect the source's property rights to confidential information.²⁰⁵ Indeed, in *Newman*, the Second Circuit focused on the injuries suffered by the investment banks and their clients whose confidential information was leaked by the investment banks' employees to third parties who subsequently traded securities based on that information.²⁰⁶ In particular, the

²⁰³ BLOOMENTHAL, *supra* note 151, at 1183.

²⁰⁴ 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

²⁰⁵ See *Newman*, 664 F.2d at 18 (stating that "investor protection was not the sole purpose" of the federal securities laws); see also Aldave, *A General Theory*, *supra* note 18, at 120 (contending that "the *Newman* Court introduced an unnecessary complication when it argued that the federal securities acts have a broader purpose than the protection of investors"); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 27 n.96 (1984) (noting that "[t]he holding in *Newman* relies squarely on a property theory to find liability under [Rule] 10b-5").

²⁰⁶ See *Newman*, 664 F.2d at 17–18 (discussed at *supra* notes 60–62 and accompanying text); see also Aldave, *A General Theory*, *supra* note 18, at 119–20 (contending that "[t]he *Newman* Court seemed to assume that it needed to identify some damage to the parties that

court noted that the defendants had “sull[ie]d] the reputations of [the investment banks] as safe repositories of client confidences”²⁰⁷ and that the defendants “also wronged [the investment banks’] clients, whose takeover plans were keyed to target company stock prices fixed by market forces, not artificially inflated through purchases by purloiners of confidential information.”²⁰⁸ The court further emphasized that an employee’s deceitful misappropriation of confidential business information is a crime punishable under a variety of federal statutes,²⁰⁹ and that it is difficult “to believe that Congress intended to establish a less rigorous code of conduct under the Securities Acts.”²¹⁰ Notably absent from the court’s opinion was any discussion about the harms experienced by the investors who had traded with the misappropriators’ tippees, or the tippee-trading’s effect on the securities marketplace as a whole.

Although *Newman* may only have intimated a property-rights based rationale for the misappropriation theory of insider trading liability, a number of securities law scholars, as well as a few courts, have articulated that rationale explicitly.²¹¹ Indeed, shortly after *Newman*, Professor (now Judge) Frank Easterbrook²¹² and Professor Jonathan Macey²¹³ each expressed the view that protecting a business’s property rights in secret information is the principal justification for reading Section 10(b) and Rule 10b-5 to prohibit the use of misappropriated information in securities transactions.²¹⁴ Judge Easterbrook’s

were deceived—the investment bankers and the acquiring companies that were their clients—in order to establish the elements of fraud”).

²⁰⁷ *Newman*, 664 F.2d at 17.

²⁰⁸ *Id.* at 17–18.

²⁰⁹ *See id.* at 18 (citing cases involving prosecutions under the federal mail fraud and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, and under the Travel Act, 18 U.S.C. § 1952).

²¹⁰ *Newman*, 664 F.2d at 18.

²¹¹ *See* authorities cited in *infra* notes 212–19; Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995); Carlton & Fischel, *supra* note 27, at 861; Edmund W. Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683, 718–19 (1980); *see also* Paul G. Mahoney, *Technology, Property Rights in Information, and Securities Regulation*, 75 WASH. U. L.Q. 815, 844 (1997) (stating that “[u]nder the misappropriation theory, insider trading is harmful and illegal not because the insider is at an informational advantage, but because the insider violated someone else’s property right in the information”).

²¹² *See* Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309.

²¹³ *See* JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* (1991); Macey, *supra* note 205.

²¹⁴ *See* MACEY, *supra* note 213, at 7–12; Easterbrook, *supra* note 212, at 330–39; Macey, *supra* note 205, at 39–56. Professor Macey and Judge Easterbrook have been particularly critical of any justification for the regulation of insider trading grounded in concepts of

scholarship particularly informed the thinking of Second Circuit Judge Ralph Winter, who summarized this "property rights" theory in his partial dissent in *United States v. Chestman*:²¹⁵

Information is perhaps the most precious commodity in commercial markets. It is expensive to produce, and, because it involves facts and ideas that can easily be photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information.²¹⁶

Thus, by proscribing securities transactions that are "in connection with" the fraudulent theft of intangible property, Section 10(b) and Rule 10b-5 are said to operate as a way to further the social good of producing information.²¹⁷ Judge Winter's rationale in *Chestman* subsequently was endorsed by a unanimous panel of the Second Circuit in *United States v. Libera*,²¹⁸ where the court expressly stated that "the purpose of the misappropriation theory . . . is to protect property rights in information."²¹⁹

b. *Investor Protection/Market Integrity Rationales*

Many securities law scholars have sharply criticized the property-rights rationale for the misappropriation theory, reasoning that the goal of protecting property rights in secret information lies outside the zones of interest of the federal securities laws.²²⁰ Traditional goals of federal securities regulation, it is

"fairness" or "market integrity." See MACEY, *supra* note 213, at 67 (contending that "[t]he regulation of insider trading cannot be justified on the grounds that it promotes the goals of efficiency, fairness, or market integrity" and that attempts to do so "simply reflect efforts by a farrago of special interest groups to obtain private advantage through the regulatory and legislative process"); Easterbrook, *supra* note 212, at 323-30 (contending that "fairness arguments get us nowhere").

²¹⁵ 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

²¹⁶ *Id.* at 576-77 (Winter, J., concurring in part and dissenting in part) (citing Easterbrook, *supra* note 212, at 313).

²¹⁷ *See id.*; *see also* Easterbrook, *supra* note 212, at 313 (stating that "[a] rule allowing information to be used freely, once in existence . . . would reduce the ability of those who create information to appropriate the benefits of their efforts; people would create less information and take costly precautions to keep what they do create").

²¹⁸ 989 F.2d 596 (2d Cir.), *cert. denied sub nom. Sablone v. United States*, 510 U.S. 976 (1993).

²¹⁹ *Id.* at 600.

²²⁰ *See* Aldave, *Carpenter and Its Aftermath*, *supra* note 18, at 378 (stating that "[t]he

argued, relate to investor protection and market integrity, and other statutory regimes or common law doctrines, including state protections for trade secrets, exist to encourage individual and corporate investments of time and money in the production of intangible property.²²¹ In part for these reasons, the investor protection and market integrity rationales traditionally invoked by the SEC to justify the misappropriation theory²²² have garnered significant scholarly

purpose of the antifraud provisions of the federal securities laws is to protect the interests of investors, not the property rights of employers or the reputations of newspapers” and noting that “if, in fact, the [*Carpenter*] defendants injured no one but the *Journal*, they should not have been convicted of violating [R]ule 10b-5”); Fisch, *supra* note 18, at 205 (noting that “[i]t is hard to see how any breach of a private duty of nondisclosure can implicate the objectives of the securities laws, which are concerned with duties to the market”); Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable*, 59 BROOK. L. REV. 149, 173–94 (1993) (reviewing BERNHARD BERGMANS, *INSIDE INFORMATION AND SECURITIES TRADING: A LEGAL AND ECONOMIC ANALYSIS OF LIABILITY IN THE USA AND EUROPEAN COMMUNITY* (1991); JONATHAN R. MACEY, *INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY* (1991); *INSIDER TRADING: THE LAWS OF EUROPE, THE UNITED STATES AND JAPAN* (Emmanuel Gaillard ed., 1992)). Professor Karmel argues that:

[A] theory that attempts to protect inside information as intellectual property . . . is . . . wide of the mark. The purpose of the securities laws is to protect investors by mandating the continuous disclosure of information by public companies . . . [Thus] in order to preserve the fairness, honesty and integrity of the public securities markets, any failure to disclose material information must be accompanied by an absence of trading informed by such information.

Karmel, *supra*, at 173.

²²¹ See Langevoort, *supra* note 16, at 878; Bainbridge, *supra* note 211, at 1257. Although he ultimately concludes that “the insider trading prohibition can be justified only as a mechanism for protecting property rights in information,” *id.* at 1269, Professor Bainbridge acknowledges that:

If one accepts protection of property rights as the rationale for regulating insider trading, it becomes quite difficult to discern any compelling federal interest in doing so. The property rights rationale makes it obvious that the federal insider trading prohibition has nothing to do with disclosure or fraud. Instead, like the trade secrets rules, the insider trading prohibition is mainly concerned with preventing employees and other fiduciaries from using information belonging to the corporation for personal gain. As such, the prohibition is unrelated to the traditional purposes of the securities laws.

Id. at 1257.

²²² See Brief for the United States at 11, *Carpenter v. United States*, 484 U.S. 19 (1987), available in LEXIS (emphasizing that “the prohibition of petitioners’ trading on misappropriated information also serves . . . the Exchange Act’s central purpose of ‘insur[ing] the maintenance of fair and honest markets . . . ’” (quoting Section 2 of the Exchange Act, 15

support. Indeed, commentators have advanced a variety of normative arguments as to why defrauding the source of information “in connection with” a securities transaction should be prohibited under Section 10(b) and Rule 10b-5,²²³ including arguments contending that securities transactions based on misappropriated information: cause damage to investors,²²⁴ are fundamentally unfair,²²⁵ contribute to the inefficient pricing of securities,²²⁶ undermine the federal securities laws’ system of mandatory disclosure,²²⁷ and compromise

U.S.C. § 78(b)). The SEC’s traditional concern for “fair and honest markets” was recently reinforced by the SEC Chairman Arthur Levitt in a speech to an audience largely composed of securities lawyers. See Arthur Levitt, *A Question of Integrity: Promoting Investor Confidence By Fighting Insider Trading*, 64 VITAL SPEECHES, Apr. 1, 1998, at 354–57. Chairman Levitt concluded his remarks with the following statements:

Investor protection is our legal mandate. Investor protection is our moral responsibility. Investor protection is my top personal priority. Let’s keep up the fight for fairness in our society. Let’s continue defending the cause of honesty in our marketplace. Let’s redouble our efforts to eradicate the crime of insider trading. It’s simply a question of integrity.

Id. at 357.

²²³ See generally NAASA Brief, *supra* note 16, at 5–9.

²²⁴ Professor Barbara Bader Aldave was one of the first securities law scholars to advance investor protection concerns as specific policy justifications for the “fraud on the source” version of the misappropriation theory. See Aldave, *A General Theory*, *supra* note 18, at 120 (contending that “one who misappropriates confidential information and uses it in his securities trading deceives the rightful owner or possessor of the information, but causes economic harm to other investors The victims of the fraud were investors.”); Aldave, Carpenter *and Its Aftermath*, *supra* note 18, at 380 (contending that the fraud at issue in *Carpenter* “damaged investors—specific if unidentifiable investors”). Professor Aldave was influenced, in part, by Professor William Wang’s arguments that insider trading directly damages contemporaneous traders in the marketplace by causing them to sell (or buy) at an improper time or price. See Wang, *supra* note 18, at 1230–40.

²²⁵ See Brudney, *supra* note 23, at 346; Kim Lane Scheppele, “*It’s Just Not Right*”: *The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123 (1993).

²²⁶ See John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y.L.J., July 31, 1997, at 6 (arguing that “the victims of insider trading are not simply those who traded with the party possessing inside information, but rather *all* shareholders, who must trade in less efficient markets because of the market makers’ need to protect themselves” from the possibility that others trading may possess nonpublic information) (emphasis added). *But see* Carlton & Fischel, *supra* note 27, at 895 (contending that federal securities laws prohibiting insider trading are inefficient and discussing arguments why such trading may contribute to market efficiency).

²²⁷ See Karmel, *supra* note 142, at 84 (contending that “prohibitions against trading on inside information should be justified as necessary to enforce the mandatory disclosure provisions of the securities laws but should extend no further”).

investor confidence in the securities markets.²²⁸

Investor protection and market integrity rationales for the misappropriation theory have also been widely accepted by lower courts presented with prosecutions for insider trading premised on the misappropriation theory. Indeed, notwithstanding obvious exceptions like *Liberia* and Judge Winter's partial dissenting opinion in *Chestman*,²²⁹ courts generally eschew the business property rationale in favor of policy goals that more clearly fit within the zones of interest of federal securities regulation.²³⁰ For example, the Second Circuit in *United States v. Carpenter*²³¹ and the district court in *SEC v. Musella*²³² each emphasized the "commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair."²³³ Similarly, in *SEC v. Clark*,²³⁴ the district court highlighted the fact that "the integrity of the marketplace is insured by holding an insider accountable for his misappropriation."²³⁵ Yet, while it clearly avoided any criticism based on "zones of interest," these investor protection and market integrity rationales for the misappropriation theory had their own analytical weakness; namely, the parties whose interests were said to be served by the imposition of liability under Section 10(b) and Rule 10b-5 (securities investors) were in most cases completely unrelated to the parties who were said to have been defrauded by the misappropriator's trading (the sources of the information).²³⁶

²²⁸ See Brudney, *supra* note 23, at 356 ("If the market is thought to be systematically populated with . . . transactors [trading on the basis of misappropriated information] some investors will refrain from dealing altogether, and others will incur costs to avoid dealing with such transactors or corruptly to overcome their unerodable informational advantages."); Seligman, *supra* note 18, at 1115 (contending that "[t]he primary policy reason for proscribing trading while in possession of material nonpublic information is to make investors confident that they can trade securities without being subject to informational disadvantages").

²²⁹ See *supra* notes 215–19 and accompanying text.

²³⁰ See Kenny & Thebaut, *supra* note 78, at 144 (noting that "the common theme" of misappropriation cases seems to be "that it is unfair to allow people to [trade] securities based on [misappropriated] information").

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

²³² 578 F. Supp. 425 (S.D.N.Y. 1984).

²³³ *Carpenter*, 791 F.2d at 1029 (quoting *Musella*, 578 F. Supp. at 438); see also *id.* at 1027 (maintaining that "[t]he fairness and integrity of conduct within the securities markets is a concern of utmost significance for the proper functioning of our securities laws").

²³⁴ 699 F. Supp. 839 (W.D. Wash. 1988), *aff'd*, 915 F.2d 439 (9th Cir. 1990).

²³⁵ *Id.* at 845; see also *id.* at 844 (asserting that Rule 10b-5 was "designed primarily 'to assure that dealing in securities is fair and without undue preferences or advantages among investors'") (quoting *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting)).

²³⁶ See Mitchell, *supra* note 18, at 826 (contending that "[t]he misappropriation theory was born schizophrenic"). In this regard, the "protection of property rights" rationale for the

2. O'Hagan's Rationale

The Supreme Court's opinion in *O'Hagan* must have been an unqualified disappointment to those securities law scholars and judges who may have been hoping to see the Court shift away from investor protection and market integrity rationales toward a misappropriation theory grounded in the value of protecting an individual's or entity's property rights to secret information. Although the Court reaffirmed its holding in *Carpenter* that a company's confidential information "qualifies as property to which the company has a right of exclusive use,"²³⁷ the Court's attention to property rights was drawn only as a means to establish that O'Hagan's "undisclosed misappropriation of such information . . . constitute[d] fraud akin to embezzlement."²³⁸ Once it established that O'Hagan's personal securities trading defrauded both Dorsey & Whitney and Grand Met, the Court's recognition of their underlying property rights in the confidential information all but disappeared from the opinion. To be sure, *O'Hagan* never mentioned a policy goal of protecting secret information, and the production of information was not emphasized as a social good in and of itself.²³⁹

Instead of grounding the misappropriation theory in a protection of property rationale, like most lower courts that had previously endorsed the misappropriation theory of insider trading liability, the *O'Hagan* Court reconciled its holding with the policy goals of protecting the integrity of the securities markets and reducing the incidence of securities transactions that are fundamentally unfair to investors. The Court, for example, acknowledged early in its opinion that "the misappropriation theory is . . . designed to 'protect[t] the integrity of the securities markets against abuses by "outsiders" to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed'"²⁴⁰ And after demonstrating that its version of the misappropriation theory comported with the language of Section 10(b), the

misappropriation theory is analytically superior to the "fair and honest markets" rationale. Whereas the fairness rationale supports a finding of Section 10(b) and Rule 10b-5 liability regardless of whether a misappropriator's securities trading operates as a fraud or deceit on investors, the "protection of property rights" rationale supports findings of liability only in those circumstances where the securities trading constitutes a fraud and deceit on the source of the information. Thus, under the "protection of property" rationale, the party who is defrauded by a misappropriator's securities trading is also the party whose interests are said to be served by the prohibitions in the rule.

²³⁷ *O'Hagan*, 117 S. Ct. at 2208.

²³⁸ *Id.*

²³⁹ See LANGEVOORT, *supra* note 18, at 6-28 (recognizing that "the Supreme Court's decision in *O'Hagan* contains no significant discussion of harm [to the source]").

²⁴⁰ *O'Hagan*, 117 S. Ct. at 2207.

Court was quick to reaffirm that its theory was “also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”²⁴¹ The Court also emphasized that “[a]n investor’s informational disadvantage *vis-à-vis* a misappropriator with material, nonpublic information stems from contrivance, not luck . . .”²⁴² and observed that “investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.”²⁴³

O’Hagan’s affinity toward the investor protection/market integrity rationales for the misappropriation theory is further evidenced by the Court’s description of the harm caused by *O’Hagan’s* securities trading. According to the Court, *O’Hagan* “deceive[d] the source of the information and *simultaneously harm[ed] members of the investing public.*”²⁴⁴ Quoting a law review article by Professor Barbara Bader Aldave, the Court explained that “a fraud or deceit can be practiced on one person, with resultant harm to another person or group of persons.”²⁴⁵ In other words, *O’Hagan’s* fraud on the source of the information was viewed by the majority as the cause of cognizable injury to other securities investors.

The majority’s perception of the harm caused by trading on misappropriated information also corresponds closely to certain views expressed by the trial judge at *O’Hagan’s* sentencing. Ostensibly, *O’Hagan* was sentenced to prison for perpetrating a fraud on his law firm and the law firm’s client within the meaning of Section 10(b) and Rule 10b-5. But the record clearly demonstrates that he was held accountable for the broader injuries that were experienced by the investors who were selling the Pillsbury securities that he was purchasing. In fact, the trial judge characterized *O’Hagan’s* fraud “as a typical insider trading case” and emphasized:

[Certainly] Dorsey and Whitney were identified as the victims, but it is obvious when you look at where the dollars came from, and the dollars certainly came, that the victims, from a pecuniary standpoint, were those who thought that they

²⁴¹ *Id.* at 2210. This statement was then supported with a quote from an SEC Release that “trading on misappropriated information ‘undermines the integrity of, and investor confidence in, the securities markets.’” *Id.* (quoting Tender Offer, Exchange Act Release No. 17120, 45 Fed. Reg. 60410 (Sept. 12, 1980)).

²⁴² *Id.* (citing Brudney, *supra* note 23, at 356; Aldave, *A General Theory*, *supra* note 18, at 122–23).

²⁴³ *O’Hagan*, 117 S. Ct. at 2210.

²⁴⁴ *Id.* at 2209 (emphasis added).

²⁴⁵ *Id.* (quoting Aldave, *A General Theory*, *supra* note 18, at 120).

were putting their options into a fair market when you weren't playing fair.²⁴⁶

Thus, like the majority in *O'Hagan*, the trial judge who sentenced O'Hagan affirmatively sought to demonstrate how his application of the misappropriation theory related to the important and well-recognized policy goals of protecting investors and ensuring fair and honest securities markets.

3. Proscribing "Fraud on the Source" to Ensure Fair and Honest Securities Markets

Although the policy justifications resonant throughout *O'Hagan* clearly root the "fraud on the source" version of the misappropriation theory in well-recognized goals of federal securities regulation, *O'Hagan's* investor protection and market integrity rationales for the "fraud on the source" misappropriation theory are ultimately unsatisfying for two separate reasons. First, as discussed in detail in the previous section, the "fraud on the source" theory of liability that is justified by that rationale captures some but not all instances of trading on misappropriated information.²⁴⁷ The "fraud on the source" theory therefore fails to achieve the very policy goals that the majority purports are served by the theory—a result that is particularly puzzling because there is nothing in the statutory text that commands it.²⁴⁸

The second significant problem presented by the "fair and honest markets" rationale for *O'Hagan's* misappropriation theory concerns the strained view of causality on which it is predicated. Indeed, as Justice Thomas pointed out in his dissent,²⁴⁹ the majority's rationale is highly misleading because it posits that deceiving the source of the information "in connection with" a securities transaction causes harm to investors and damages confidence in securities markets. Yet, those harms are actually caused by the misappropriator's *use* of the misappropriated information in securities trading rather than by the misappropriator's fraudulent nondisclosure to the source. Using the damage done to investors and the securities markets to justify imposing criminal liability for a fraud that was actually perpetrated on the information's source subjects

²⁴⁶ Transcript of Sentencing at 28, *United States v. James Herman O'Hagan* (Oct. 27, 1994) (Crim. No. 4-92-219), quoted in Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 8–9 n.7, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), available in 1997 WL 143793 [hereinafter Law Professors-Respondent Brief].

²⁴⁷ See *supra* Part III.A.

²⁴⁸ See *infra* Part IV.A (contending that the statutory text would support a broader misappropriation theory that would better effectuate the Court's policy goals).

²⁴⁹ See *O'Hagan*, 117 S. Ct. at 2225 (Thomas, J., concurring in the judgment in part and dissenting in part).

O'Hagan to the charge that its misappropriation theory is merely a backhanded way to penalize individuals for reducing investor confidence in the securities markets and for treating investors unfairly.

a. *O'Hagan's Failure to Produce a Theory That Achieves Its Goals*

O'Hagan's "fraud on the source" version of the misappropriation theory is at once too narrow and too broad. Although the practical implications of its narrowness was discussed extensively in the previous section,²⁵⁰ the restrictive scope of *O'Hagan's* reasoning merits brief re-examination here due to the dissonance between the rationale used in *O'Hagan* to justify the misappropriation theory and the type of conduct that is actually prohibited by the particular version it endorsed. Indeed, the "fraud on the source" version of the misappropriation theory is woefully under-inclusive in that it fails to prohibit a whole variety of securities transactions based on misappropriated information that, under the majority's rationale, would be as unfair to investors and as harmful to securities markets as the particular trading accomplished by *O'Hagan*.²⁵¹

Ironically, the majority's own words reveal precisely why *O'Hagan's* under-inclusiveness is so troubling. After discussing how and why the "fraud on the source" theory was "well-tuned" to "insure honest markets" and "to promote investor confidence," the majority concluded that it would make "scant sense" to make *O'Hagan's* liability turn on whether his law firm represented in a tender offer the target or the bidder. Arguments based on "sense," however, are particularly nettlesome for *O'Hagan's* majority because the very same arguments can be made regarding the types of individuals who are foreclosed from liability under *O'Hagan's* theory. The argument would go something like this:

Considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like *O'Hagan* a § 10(b) violator if he works for a law firm representing [the bidder in] a tender offer,²⁵² [but not if he hacks into the bidder's computer to learn that confidential information, or if he breaks into a stranger's office to steal such information, or if he discloses to his own law firm and client that he intends to use this confidential information in his personal securities trading].

²⁵⁰ See *supra* Part III.A.

²⁵¹ See *supra* Part III.A.

²⁵² *O'Hagan*, 117 S. Ct. at 2210–11.

To quote *O'Hagan* again, "investors likely would hesitate to venture their capital in a market where [such] trading based on misappropriated nonpublic information is unchecked by law."²⁵³

Had the *O'Hagan* majority considered and rejected alternative formulations of the misappropriation theory, it may have been poised to argue that its version of the theory, while only a partial antidote for the problems it was designed to alleviate, is nonetheless the only viable theory that fits within the textual limitations of Section 10(b) and Rule 10b-5. But the *O'Hagan* majority never considered (or at least never acknowledged that it considered) whether there were alternative theories that would exhibit a similarly faithful adherence to the text of Section 10(b) and Rule 10b-5 while at the same time would extend liability to situations beyond the scope of a theory of liability premised on fraud on the source.²⁵⁴ In the absence of such careful considerations, *O'Hagan*'s "fraud on the source" misappropriation theory itself makes "scant sense" because it fails to achieve the very policy goals that the Court advances to justify its endorsement.²⁵⁵

b. *The Pretextual Nature of O'Hagan's Misappropriation Theory*

The other great irony presented by the majority's reasoning in *O'Hagan* concerns the fact that while the misappropriator's interaction with investors in the marketplace is legally irrelevant to the textual question of whether the source of the information was deceived and defrauded "in connection with" a securities transaction, the misappropriator's effect on the securities market is precisely the normative justification put forth by the majority as to why such conduct should be subject to prohibition under Section 10(b) and Rule 10b-5.²⁵⁶ *O'Hagan*'s

²⁵³ *Id.* at 2210. The majority's failure to treat similar cases similarly drew Justice Thomas to remark: "Even if it is true that trading on nonpublic information hurts the public, it is true whether or not there is any deception of the source of the information." *Id.* at 2225–26 (Thomas, J., concurring in the judgment in part and dissenting in part).

²⁵⁴ See *infra* notes 385–92 and accompanying text (contending that *O'Hagan* focused exclusively on the validity of the "fraud on the source" theory advanced by the Government and therefore left the validity of a broader misappropriation theory for future resolution).

²⁵⁵ Other securities law scholars have also pondered the restrictive scope of *O'Hagan*'s misappropriation theory. See Painter et al., *supra* note 142, at 187 ("Given the Court's insistence that trading covered by the misappropriation theory 'harms members of the investing public,' it is difficult to understand how the Court can exclude from the theory's reach such conduct that has an identical effect on the investing public.").

²⁵⁶ Cf. Mitchell, *supra* note 18, at 778–80 (contending that the "fraud on the source" misappropriation theory "braid[s] together" two competing theoretical approaches to insider trading: the post-*Chiarella* approach that focuses on the wrongfulness of an individual actor's conduct in trading securities based on misappropriated information, and the Second Circuit's

attention to harms done to the securities markets by trading on the basis of misappropriated information is troubling because it evidences that the “fraud on the source” version of the misappropriation theory may be functioning largely as a pretext for enforcing the parity of information approach that was rejected by the Supreme Court in *Chiarella* and *Dirks*.²⁵⁷ That is, the “fraud on the source” version of the theory allows courts to “catch” unfairness to investors within the proscriptions of Section 10(b) and Rule 10b-5 without the necessity of having to characterize the unfairness as “fraud.”

The majority in *O'Hagan* appeared to be unconcerned that it was imposing criminal liability for a fraud perpetrated on the source of the information, not because of the damage done to that source, but because of the damage done to individual investors and the securities market as a whole. The Court seemed to view this substitution of victims as both necessary and appropriate because the fraud perpetrated on the source purportedly caused injuries that properly fell within the ambit of federal securities regulation: a misappropriator's securities trading “deceives the source of the information and simultaneously harms members of the investing public.”²⁵⁸

O'Hagan's claim that investors are harmed by a misappropriator's securities trading certainly has some intuitive appeal. But here it is important to return to *O'Hagan's* description of the conduct that is said to run afoul of the prohibitions of Section 10(b) and Rule 10b-5. To satisfy *Santa Fe's* clear dictate that deception—and not merely a breach of fiduciary duty—must be demonstrated to state a cause of action under Section 10(b) and Rule 10b-5, *O'Hagan* separated the act of using stolen information in securities trading (the breach of duty) from the act of failing to inform the principal about the intent to use that stolen information to trade securities (the deception).²⁵⁹ Yet once it demonstrated that *Santa Fe's* requirement of deception was satisfied in insider trading cases premised on the misappropriation theory, *O'Hagan* blurred the deception with the securities trading for purposes of establishing a harm that fell within the zones of interests properly protected under the federal securities laws. The problem is that the specific conduct which is said to violate Section 10(b) and Rule 10b-5 (nondisclosure to the source about one's intent to trade) is not in any

pre-*Chiarella* approach that focuses far less on the wrong done by the individual, and far more on the effect that an individual's activities has on the integrity of the securities markets).

²⁵⁷ See Charles C. Cox & Kevin S. Forgarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 366 (1988) (maintaining that under a misappropriation theory premised on fraud on the source, “the breach involved may seem trivial in terms of the harm done to the person to whom the duty is owed, suggesting that the whole theory is merely a pretext for enforcing equal opportunity in information”).

²⁵⁸ *O'Hagan*, 117 S. Ct. at 2209.

²⁵⁹ See *id.* at 2208–09.

real sense the cause of the injury to individual investors or the securities marketplace.²⁶⁰ As Justice Thomas pointed out in his dissent, the injury to investors is caused by the misappropriator's *use* of material, nonpublic information in a securities transaction—an injury that occurs whether or not deception within the meaning of Section 10(b) is involved.²⁶¹

To illustrate this point, it is useful to separate out the fraud perpetrated on the source from the injury ultimately experienced by those individuals trading in the market at the same time as the misappropriator. The only injury proximately caused by the deception (as defined by *O'Hagan*) is an injury to the source of the information who is "duped" into believing that the fiduciary is loyal and trustworthy, while the reality evidences otherwise. The injury resulting from the deception is therefore one of betrayal and the repercussions (financial or otherwise) that flow from it.²⁶² In contrast, individuals and the securities markets are harmed, not from the misappropriator's deception of the source, but from the very fact that the misappropriator was *using* stolen information in his securities trading. That this injury stems from the trading, and not from the illegal deception, is evidenced by the fact that brazen fiduciaries injure investors and securities markets in much the same way as deceitful ones.²⁶³ Imposing liability

²⁶⁰ See Painter et al., *supra* note 142, at 168 n.57 (stating that "it is difficult to conceptualize how public investors are any worse off simply because the person with whom they trade did not disclose her intent to trade to the source of her information").

²⁶¹ See *O'Hagan*, 117 S. Ct. at 2226 & n.7 (Thomas, J., concurring in the judgment in part and dissenting in part). Justice Thomas correctly identifies the majority's error as one "[c]onflating causation with correlation." *Id.* at 2226 n.7. He explains:

That the misappropriator may both deceive the source and "simultaneously" hurt the public no more shows a causal "connection" between the two than the fact that the sun both gives some people a tan and "simultaneously" nourishes plants demonstrates that melanin production in humans causes plants to grow. In this case, the only element common to the deception and the harm is that both are the result of the same antecedent cause—namely, using non-public information. But such use, even for securities trading, is not illegal, and the consequential deception of the source follows an entirely divergent branch of causation than does the harm to the public.

Id. at n.7 (quoting majority opinion at 2209). See also Painter et al., *supra* note 142, at 185 n.132 (emphasizing that "[t]he 'harm' to investors that coincides with this deception of a third party links the misappropriation theory with the overall purpose of the statute, but is still entirely distinct from the breach that is the linchpin of the violation").

²⁶² See *supra* notes 205–10 and accompanying text (discussing the Second Circuit's attention in *United States v. Newman* to reputational and financial injuries caused by the defendant's trading).

²⁶³ See *supra* notes 168–78 and accompanying text (discussing *O'Hagan's* liability loophole for brazen fiduciaries).

under Section 10(b) and Rule 10b-5 for defrauding the source “in connection with” a securities transaction therefore seems to be a means of carrying out an end otherwise barred by the dictates of *Chiarella* and *Dirks*: defendants are prosecuted for their “unfair,” though not necessarily fraudulent, treatment of investors and for the damage done to public confidence in the securities markets.²⁶⁴

Provided the textual requirements of Section 10(b) and Rule 10b-5 have been satisfied, is there any real harm in substituting victims in insider trading cases premised on the misappropriation theory?²⁶⁵ Several reasons account for why a “fraud on the source” misappropriation theory that is viewed as a pretext

²⁶⁴ See *O’Hagan*, 117 S. Ct. at 2225–26 (Thomas, J., concurring in the judgment in part and dissenting in part) (citing *Chiarella*, 445 U.S. at 232–33, for the proposition that “use of nonpublic information to trade is not itself a violation of § 10(b)” and emphasizing that “regardless of the overarching purpose of the securities laws, it is not illegal to run afoul of the ‘purpose’ of a statute, only its letter”); see also Peter J. Henning, *Between Chiarella and Congress: A Guide to the Private Cause of Action for Insider Trading Under the Federal Securities Laws*, 39 KAN. L. REV. 1, 4 (1990) (contending that the “fraud on the source” misappropriation theory has allowed the government to “effectively bypass the holdings of *Chiarella* and *Dirks*”).

²⁶⁵ The *O’Hagan* Court’s readiness to substitute victims to bolster the “fraud on the source” misappropriation theory with a convincing policy rationale can be compared with the substitution of victims that has generally occurred when lower courts have analyzed the element of materiality in misappropriation cases. That is, although courts view the misappropriator’s deception of the source of the information as the fraud prohibited by Section 10(b) and Rule 10b-5, the materiality standard utilized by almost all lower courts in determining the existence of a fraud has focused on whether *investors* would have considered the misappropriated information important in deciding whether to purchase or sell the security. See, e.g., *SEC v. Maio*, 51 F.3d 623, 637 (7th Cir. 1995) (concluding that misappropriated information met Rule 10b-5’s materiality requirement because there was “a substantial likelihood . . . that a reasonable investor would find [it] significant in deciding whether to buy or sell a security, and on what terms to buy or sell” (quoting *Rowe v. Maremount Corp.*, 850 F.2d 1226, 1232–33 (7th Cir. 1988) (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988))); see also *United States v. Carpenter*, 791 F.2d 1024, 1032 n.9 (2d Cir. 1986) (citing *TSC Indust., Inc. v. Northway Inc.*, 426 U.S. 438, 449 (1976)). But evaluating materiality in insider trading cases from the vantage point of a potential investor makes sense only if the fraud prohibited by Section 10(b) and Rule 10b-5 consists of the trader’s failure to disclose the nonpublic information to the persons on the other side of the securities transaction. If the fraud consists of a trader’s failure to disclose personal securities transactions to the source of the information, it would be far more logical to inquire whether the misappropriated information “is solely for corporate purposes” and if a reasonable corporate executive would believe keeping that information confidential was valuable to the corporation.” *United States v. Elliott*, 711 F. Supp. 425, 433 (N.D. Ill. 1989) (quoting *Dirks v. SEC*, 463 U.S. 646, 655 (1983)). Yet this type of materiality standard, while clearly more fitted to the gravamen of a “fraud on the source” complaint, has been adopted on only one occasion by a single district court. See *Elliott*, 711 F. Supp. at 432–33.

is so troubling.

First, Section 10(b) and Rule 10b-5's prophylactic effect against insider trading may be compromised if the misappropriation theory is viewed as merely a pretext for prosecuting the unfair, though not necessarily illegal, treatment of investors. In this regard, noted social scientists have theorized that individuals tend to obey the law primarily out of a sense of obligation and respect for the rule of law—fear of “getting caught” ranks as a lower motivational force.²⁶⁶ Thus, individuals who view the law as a pretext for taking action against conduct that is not explicitly recognized as illegal are probably less likely to take the law seriously.²⁶⁷

Second, and once again ironically, because the “fraud on the source” version of the misappropriation theory implicitly acknowledges that the federal securities laws fail to provide investors with direct protection against outsiders who trade on misappropriated information, public confidence in the securities markets may actually be undermined. As the Court itself recognized in *O'Hagan*, investors' willingness to invest money in the securities markets is largely a function of their confidence level in the fairness and integrity of those markets.²⁶⁸ Investors may take little solace in the fact that they are only indirectly protected from unfair securities transactions and only in those particular cases when the nonpublic information was obtained by a fiduciary who owed a duty of trust and confidence to the source.

Finally, premising liability on a fraud that is perpetrated on the source of nonpublic information results in substantial reputational injury to the SEC because the agency appears to be using Section 10(b) and Rule 10b-5

²⁶⁶ See, e.g., Tom R. Tyler, *Public Mistrust of the Law: A Political Perspective*, 66 U. CIN. L. REV. 847, 856 (1998) (stating that “[i]t is difficult to gain sufficient compliance to enforce the law using only the threat of punishment Research suggests that, in democratic societies such as the United States, the effectiveness of both political and legal authorities is heavily dependent upon the willing, voluntary cooperation of citizens with laws and legal decisions.”); Harold G. Grasmick & Robert J. Bursik, Jr., *Conscience, Significant Others, and Rational Choice: Extending the Deterrence Model*, 24 LAW & SOC'Y REV. 837, 837–39 (1990) (discussing research suggesting that moral concerns may be more important than legal sanctions in explaining future intentions regarding crime).

²⁶⁷ See Tyler, *supra* note 266, at 858–60 (discussing research revealing that the public's perception of the law's “legitimacy” is important to gaining voluntary compliance); see also Tom R. Tyler, *Compliance With Intellectual Property Laws: A Psychological Perspective*, 29 N.Y.U. J. INT'L L. & POL. 219, 225 (1996–1997) (discussing studies and concluding that “the way people behave is primarily a reflection of their views about: (1) what is right and wrong and (2) their obligations to the law and to legal authorities”).

²⁶⁸ See *O'Hagan*, 117 S. Ct. at 2210 (recognizing that while “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”).

illegitimately—to penalize unfair conduct *vis-à-vis* investors that is not itself recognized as unlawful under these provisions.²⁶⁹ Indeed, the public may view the defendants in misappropriation cases as being treated unjustly, by a legal system that imposes penalties for treating investors unfairly, even though such unfairness does not, in and of itself, violate the law.²⁷⁰ One can see this from the position taken by the *amicus curiae* supporting O'Hagan as his case went to the Supreme Court,²⁷¹ and in the subsequent criticism that has been launched at the majority's decision.²⁷²

As a securities lawyer, O'Hagan certainly knew that his treatment of investors ran afoul of the spirit of the Exchange Act. It is unfortunate that judicial reasoning has muddied the waters on the question of whether his treatment of investors (as opposed to his treatment of the source of the information) also violated the letter of Section 10(b) and Rule 10b-5. If the majority in *O'Hagan* believed that investors and the securities markets needed protection from those persons who trade securities on the basis of misappropriated information, then the majority should have looked beyond the pretextual "fraud on the source" theory to recognize an alternative theory under which the failure to disclose to investors could itself be considered fraudulent activity within the meaning of Section 10(b) and Rule 10b-5.²⁷³

²⁶⁹ Part IV.A *infra* contends that trading securities based on misappropriated information not only treats investors unfairly, but also deceives and defrauds investors within the meaning of Section 10(b) and Rule 10b-5. But until a court explicitly recognizes the validity of this theory, defendants in "fraud on the source" misappropriation cases will continue to pay a penalty (literally as well as figuratively) for their unfair, as opposed to unlawful, treatment of investors.

²⁷⁰ Cf. Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 68 (1980) (stating that "[b]ecause the conduct regulated differs from the conduct [Rule 10b-5] is intended to cover, the sanctions imposed [for insider trading] are unrelated to the defendants' behavior and therefore arbitrary"); Karjala, *supra* note 18, at 1532 (contending that the imposition of liability "for the defendant's wrongful act is proper only when the injury is of a type with respect to which defendant's conduct is deemed wrongful . . .").

²⁷¹ See Law Professors-Respondent Brief, *supra* note 246, at 8–9 n.7 (emphasizing that O'Hagan "was found guilty of violating § 10(b) under the misappropriation theory, but was sentenced to prison by a judge who, once the parameters of the misappropriation theory were met, viewed [O'Hagan's] actions under a theory much more akin to the parity of information theory rejected by [the] Court in *Chiarella*").

²⁷² See Swanson, *supra* note 142, at 1160 (criticizing *O'Hagan* for "advancing policy rationales not consistent with the holding"); see also Kathryn Keneally, *Outside-In On Insider Trading*, 21 CHAMPION 33, 36 (1997) (describing *O'Hagan* as "result-oriented" and criticizing the majority for "wrongly creat[ing] an entirely new theory of law").

²⁷³ See *infra* Part IV.A.

C. O'Hagan and Private Rights of Actions for Insider Trading

The *O'Hagan* opinion has thus far been criticized for its restrictiveness in framing the scope of the conduct that triggers liability under Section 10(b) and Rule 10b-5 and for its failure to infuse the misappropriation theory with a rationale that ties the prohibited conduct to a recognized goal of federal securities regulation. These two criticisms, however, are linked inextricably to *O'Hagan's* third principal shortcoming: a "fraud on the source" version of the misappropriation theory is very difficult to reconcile with both judicial and congressional determinations as to which private parties have standing to pursue actions alleging violations of Section 10(b) and Rule 10b-5 based on a defendant's insider trading. Indeed, if *O'Hagan* is correct that the source of the information is the party who is defrauded by the misappropriator's trading within the meaning of Section 10(b) and Rule 10b-5, then one would expect to see questions of standing in insider trading cases brought by private plaintiffs resolved in a manner that is very different from the way that they are resolved under prevailing law.

1. Standing in Insider Trading Cases

Private plaintiffs generally initiate actions alleging insider trading pursuant to one of two statutory avenues: an implied right of action under Rule 10b-5²⁷⁴ or an express right of action under Exchange Act Section 20A.²⁷⁵ In cases involving insider trading premised on the misappropriation theory, neither of these provisions typically permit the source of the misappropriated information to recover damages from the person who used that information in connection with a securities transaction.²⁷⁶ Persons who have violated Section 10(b) and Rule 10b-5 by trading on misappropriated information are, however, liable to "contemporaneous traders" who sue under the express right of action codified in Section 20A.²⁷⁷

²⁷⁴ Although Rule 10b-5 is silent with respect to whether private parties may institute legal action against defendants who violate the rule, the Supreme Court has stated that the existence of an implied private right of action under Rule 10b-5 "is simply beyond peradventure." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983); *see also* *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971) (first decision by the Court confirming existence of implied right of action under Rule 10b-5).

²⁷⁵ *See* 15 U.S.C. § 78t-1 (1994) (quoted *infra* text accompanying note 290).

²⁷⁶ *See infra* text accompanying notes 278-84, 295.

²⁷⁷ *See infra* text accompanying notes 289-92.

a. *Implied Rights of Action Under Rule 10b-5*

The Supreme Court's decision in *Blue Chip Stamps v. Manor Drug Stores*²⁷⁸ imposes a condition that most sources of information will be unable to satisfy in implied actions for damages under Rule 10b-5. This case set forth what is now the rule that standing to sue in private actions under Rule 10b-5 is limited to "actual purchasers or sellers" of securities.²⁷⁹ The corporate plaintiff in *Blue Chip Stamps* alleged that it had relied on fraudulent statements by the defendant-issuer in reaching its determination *not* to purchase the defendant's securities.²⁸⁰ Although the Court did not deny that the plaintiff may have been defrauded by the defendant's misstatements, it narrowly construed the statutory language to be "directed toward injury suffered 'in connection with the purchase or sale' of securities."²⁸¹ The Court therefore reasoned that without a purchase or sale of any security, the plaintiff could not assert an injury covered within the scope of the statute.²⁸²

Blue Chip Stamps therefore precludes most principals from suing their fiduciaries for violating Section 10(b) and Rule 10b-5 by trading on misappropriated information.²⁸³ For example, even though the Second Circuit

²⁷⁸ 421 U.S. 723 (1975).

²⁷⁹ See *id.* at 730–31 (endorsing the Second Circuit's so-called "Birnbaum rule" that standing to assert private cause of action for damages under Rule 10b-5 was limited to actual "purchasers and sellers of securities").

²⁸⁰ See *id.* at 726–27.

²⁸¹ *Id.* at 733; see also *id.* at 734 (noting that "[w]hen Congress wished to provide a remedy to those who neither purchase nor sell securities, it had little trouble in doing so expressly").

²⁸² See *id.* at 733; see also *id.* at 755–61 (Powell, J., concurring) (writing separately to emphasize the language of Section 10(b) and Rule 10b-5).

²⁸³ If the source of the misappropriated information were an actual purchaser or seller of securities, and incurred damages caused by the misappropriator's securities trading, then the Court's holding in *Blue Chip Stamps* would not foreclose standing under Rule 10b-5. Such a situation might arise in a merger or tender offer context in which an acquiring corporation had to increase its offering price for a target's shares because a fiduciary's insider trading caused the market price of the target's stock to rise. See, e.g., *Litton Indus., Inc. v. Lehman Brothers Kuhn Loeb, Inc.*, 967 F.2d 742 (2d Cir. 1992) (acquiring corporation had standing to assert implied action under Rule 10b-5 against its investment banker for insider trading that may have resulted in the target's acquisition at a higher price); *Anheuser-Busch v. Thayer*, No. CA3-85-0794-R (N.D. Tex. Apr. 26, 1985) (settlement of private action under Rule 10b-5 against director of acquiring company whose alleged insider trading in the target's securities caused the target's stock price to rise dramatically, thereby increasing Anheuser-Busch's total cost of acquiring the target); see also Gregory S. Crespi, *The Availability after Carpenter of Private Rights of Action under Rule 10b-5 Based Upon the Misappropriation of Information Concerning Acquisitions*, 26 AM. BUS. L.J. 709, 719–22 (1989) (analyzing cases where

held in *Carpenter* that the *Wall Street Journal* had been deceived and defrauded by the defendant-reporter's (and his tippees') securities trading,²⁸⁴ the *Wall Street Journal* would have lacked standing to assert an implied right of action under Rule 10b-5 against the reporter and his tippees because the *Journal* was not a purchaser or seller of securities.

Blue Chip Stamps's limitation, however, does not foreclose standing in Rule 10b-5 actions brought by those investors who traded with the person whose securities transactions were based on misappropriated information. As "actual purchasers or sellers" of securities, such investors are able to satisfy the statutory requirement that their injuries occurred "in connection with" a securities transaction. Instead, investors seeking to recover damages in implied causes of action under Rule 10b-5 must defeat the hurdle erected by the Second Circuit in *Moss v. Morgan Stanley Inc.*²⁸⁵ Recall that *Moss* involved a Rule 10b-5 suit by a private plaintiff who unwittingly sold shares in a soon-to-be tender offer target.²⁸⁶ The plaintiff sought to recover damages against multiple defendants, including tippees who had purchased the target's securities at a bargain price based on misappropriated information regarding the upcoming tender offer. Rejecting the argument advanced by the SEC as *amicus curiae*,²⁸⁷ the Second Circuit concluded that the plaintiff lacked standing under Rule 10b-5 to assert a claim for damages against the defendants because the misappropriators and their tippees did not owe the plaintiff any duty to disclose the nonpublic information on which their securities transactions were based.²⁸⁸

b. *Express Rights of Action Under Section 20A*

Without congressional intervention, private actions for damages against persons who violate Section 10(b) and Rule 10b-5 by trading on misappropriated information may well have been foreclosed by the combined effect of the Supreme Court's holding in *Blue Chip Stamps* and the Second Circuit's holding in *Moss v. Morgan Stanley Inc.* However, in 1988, as part of the Insider Trading and Securities Fraud Enforcement Act ("TTSFEA"),²⁸⁹ Congress added Section

fiduciaries traded on information obtained through work for corporate clients); Jeanne M. Hauch, Note, *Insider Trading by Intermediaries: A Contract Remedy for Acquirers' Increased Costs of Takeovers*, 97 YALE L.J. 115, 120-23 (1987) (same).

²⁸⁴ See *supra* text accompanying notes 64-67.

²⁸⁵ 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

²⁸⁶ See *id.* at 8-9. *Moss* is discussed extensively at *supra* notes 88-99 and accompanying text.

²⁸⁷ See *supra* note 91.

²⁸⁸ See *Moss*, 719 F.2d at 16.

²⁸⁹ Pub. L. 100-704, 102 Stat. 4677 (1988) (codified at various sections, 15 U.S.C. § 78

20A to the Exchange Act, providing an express private right of action against insider traders. Section 20A provides that:

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.²⁹⁰

Thus, if a “contemporaneous trader”²⁹¹ can show that a defendant’s securities trading constituted a violation of Section 10(b) and Rule 10b-5, then the contemporaneous trader has a statutory right to recover damages against that defendant.²⁹²

ITSFEA’s legislative history reflects that Section 20A was enacted to legislatively overturn the Second Circuit’s determination in *Moss* that third party

(1994)).

²⁹⁰ 15 U.S.C. § 78t-1(a) (1994). Section 20A further provides an express right of action against tippers, specifying that “communicating material, nonpublic information” in violation of the Exchange Act or rules or regulations thereunder renders such a person “jointly and severally liable . . . to the same extent as [the person] to whom the communication was directed.” 15 U.S.C. § 78t-1(c) (1994).

²⁹¹ In Section 20A, Congress chose not to define the term “contemporaneously;” instead, the drafters sought to adopt the definition of the term “which has developed through case law.” HOUSE COMM. ON ENERGY AND COMMERCE, INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. NO. 100-910, at 27 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6064 [hereinafter ITSFEA House Report]. Here, the ITSFEA House Report was referring to decisions by lower courts that, under the classical theory of insider trading, had permitted private plaintiffs to seek damages against corporate insiders for violating Section 10(b) and Rule 10b-5 by trading securities while in possession of material, nonpublic information. *See, e.g.,* *Wilson v. Comtech Telecomm. Corp.*, 648 F.2d 88, 94–95 (2d Cir. 1981) (holding that the scope of liability for implied actions under Rule 10b-5 is confined to persons who traded “contemporaneously” with a corporate insider) (cited in ITSFEA House Report, H.R. REP. NO. 100-910, at 27 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6063). In general, to be considered a “contemporaneous trader,” a person must have purchased or sold their securities at the same time or within no more than a few days after the defendant’s illegal trading. *See FERRARA ET AL., supra* note 18, at § 3.02[3] (discussing cases); WANG & STEINBERG, *supra* note 18, at 395–400 (same).

²⁹² Section 20A’s relatively generous standing provision is somewhat tempered by its limitations on a defendant’s liability, which provides specifically that the total amount of damages imposed “shall not exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation,” an amount that is further offset by any disgorgement paid to the SEC. 15 U.S.C. § 78t-1(b) (1994).

investors lack standing to sue when a defendant's violation of Section 10(b) and Rule 10b-5 is premised on the misappropriation theory.²⁹³ Specifically, Congress determined that the result in *Moss* was "inconsistent with the remedial purposes of the Exchange Act."²⁹⁴ ITSFEA's legislative history further reflects that Congress considered, but chose not to extend, an express cause of action to any persons other than contemporaneous traders.²⁹⁵

2. *Anomalies Presented by Judicial and Congressional Determinations of Standing*

If the majority in *O'Hagan* is correct that defrauding the source of information through personal securities trading constitutes a violation of Section 10(b) and Rule 10b-5, and that trading on the basis of misappropriated information harms investors but does not necessarily defraud them, then we would expect to see a very different legal landscape of standing in insider trading cases from the one that exists today. Indeed, if sources of information are the actual victims of the fraud that is proscribed under Section 10(b) and Rule 10b-5, one must ask why Congress refused to grant these victims an express right of action to recover damages from the individuals who defrauded them within the meaning of the federal securities laws.²⁹⁶ Congress would certainly have been

²⁹³ See ITSFEA House Report, H.R. REP. NO. 100-910, at 26-27 (1988), *reprinted in* 1998 U.S.C.C.A.N. 6043, 6063 (noting that "[i]n particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory" and citing *Moss v. Morgan Stanley Inc.*).

²⁹⁴ *Id.* at 27.

²⁹⁵ See *id.* at 28. The ITSFEA House Report recognized that "there clearly are injuries caused by insider trading to others beyond contemporaneous traders," but the Committee believed that Section 10(b) and Rule 10b-5 had "sufficient flexibility" to protect such noncontemporaneous traders. See *id.* at 27-28. The ITSFEA House Report then went on to discuss the Rule 10b-5 action filed by Anheuser-Busch against its former director in which the company alleged that it suffered damages because the defendant's insider trading caused it to pay a higher price to complete an acquisition. See *supra* note 283. Viewing Anheuser-Busch as a clear victim of the director's securities trading based on misappropriated information, the ITSFEA House Report maintained that "where the plaintiff can prove that it suffered injury as a result of the defendant's insider trading, the plaintiff has standing to sue in this circumstance, and the remedial purposes of the securities laws require recognition of such an action." ITSFEA House Report, H.R. REP. NO. 100-910, at 28 (1988), *reprinted in* 1998 U.S.C.C.A.N. 6043, 6065. Section 20A(d) codifies this determination by making clear that nothing in Section 20A "shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of this title." 15 U.S.C. § 78t-1(d) (1994).

²⁹⁶ See *supra* note 295.

aware that most sources of information defrauded by a misappropriator's securities trading would be unable to satisfy the "actual purchaser and seller" requirement read into Section 10(b) by the Supreme Court in *Blue Chip Stamps*.²⁹⁷ If Congress believed that sources of information were the actual victims of a misappropriator's securities fraud, then extending standing to these victims would seem logical.

What is even more curious is why Congress would have granted standing to contemporaneous traders in the marketplace if Congress had agreed with *Moss*'s holding that investors who trade with misappropriators are not deceived and defrauded.²⁹⁸ Congress clearly viewed *Moss*'s result as "inconsistent with the remedial purposes of the Exchange Act."²⁹⁹ Yet whose injury did Congress believe needed to be remedied? If the source of the information is the only party who is deceived and defrauded within the meaning of Section 10(b) and Rule 10b-5, then it would make no sense to provide contemporaneous traders with standing in misappropriation cases.³⁰⁰ Yet, if investors' injuries need to be remedied, then it makes equally little sense to permit recovery under the federal securities laws unless such investors were deceived and defrauded within the meaning of those laws. The unprincipled compromise that *O'Hagan* tries to strike—that investors are hurt but not necessarily defrauded³⁰¹—simply does not provide a justification for why contemporaneous traders should be accorded standing to recover damages against persons who tip or trade on misappropriated information.

Thus, read together, *O'Hagan*, *Blue Chip Stamps*, and Section 20A set up a rather curious paradox: Section 20A grants contemporaneous traders a right to sue misappropriators for violating Section 10(b) and Rule 10b-5 even though

²⁹⁷ Congressional awareness of judicial limitations on standing under Rule 10b-5 is indicated by the ITSFEA House Report's fixation on the damages to securities purchasers (particularly acquiring corporations in the tender offer context) when a fiduciary trades those same securities on the basis of misappropriated information. *See supra* note 295. Indeed, while the ITSFEA House Report spoke approvingly of the Second Circuit's decision in *Carpenter*, it nowhere suggested that the *Wall Street Journal* could or should possess standing under Rule 10b-5 to recover damages from the defendants who were previously convicted under the misappropriation theory. *See* ITSFEA House Report, H.R. REP. NO. 100-910, at 30 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6067 (discussing facts and holding in *Carpenter*).

²⁹⁸ *See supra* notes 92–96 and accompanying text.

²⁹⁹ ITSFEA House Report, H.R. REP. NO. 100-910, at 27 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6064.

³⁰⁰ *Cf.* MACEY, *supra* note 213, at 59 (advocating a property-rights based misappropriation theory and contending that "[t]he rules of standing under [Rule] 10b-5 should reflect the injury to the owner of the information, not necessarily the people with whom the insider has traded").

³⁰¹ *See supra* text accompanying notes 130–31.

their injury under these provisions remains legally unrecognized by the Supreme Court, while *Blue Chip Stamps* ensures that most sources of misappropriated information will be unable to demonstrate standing, even though *O'Hagan* acknowledges that they have been deceived and defrauded within the meaning of Section 10(b) and Rule 10b-5.³⁰² A theory of liability that creates such anomalous results calls out for reconsideration.

IV. REFRAMING THE MISAPPROPRIATION THEORY BY EMPHASIZING A FRAUD ON INVESTORS

The foregoing critique of the *O'Hagan* decision brings to light a number of fundamental problems with the “fraud on the source” theory. In view of these problems, this Part proposes a way to reframe the misappropriation theory. Rather than predicating the fraud under Section 10(b) and Rule 10b-5 on a fiduciary's deceptive breach of a duty owed to the source of confidential information, trading based on misappropriated information should be viewed as a fraud perpetrated on those investors who traded in the marketplace contemporaneously with the person using the misappropriated information. Not surprisingly, Chief Justice Burger's contentions in *Chiarella* provide the starting place for constructing a new misappropriation theory that premises Section 10(b) and Rule 10b-5 liability on a breach of duty to disclose unlawfully obtained information.³⁰³ This Part builds upon those contentions and seizes compelling support from a variety of additional sources.

A. Applying a “Disclosure or Abstain” Rule to Trading Based on Misappropriated Information

Although the antifraud prohibitions in Section 10(b) and Rule 10b-5 are not entirely coextensive with common law doctrines of fraud and deceit,³⁰⁴ the Supreme Court traditionally has looked to those common law causes of action in determining the type of “manipulative or deceptive” conduct that Congress

³⁰² See Macey, *supra* note 205, at 48 (contending that “[i]n light of the Court's fiduciary duty analysis, it seems ironic that the only persons who may bring a private suit for violations of Rule 10b-5 are purchasers and sellers who have bought or sold during the time the insiders were trading”).

³⁰³ See *supra* notes 53–57 and accompanying text; see also Langevoort, *supra* note 16, at 883–85.

³⁰⁴ See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 388–89 (1983); see also *Meyers v. Moody*, 693 F.2d 1196, 1214 (5th Cir. 1982) (noting that “the common law of fraud is generally more stringent in its requirements than the elements of Rule 10b-5 . . .”).

sought to proscribe "in connection with the purchase or sale of any security."³⁰⁵ Thus, in deciding whether securities trading on the basis of misappropriated information deceives contemporaneous traders in the marketplace within the meaning of Section 10(b) and Rule 10b-5, it is to the common law that we must first turn.

1. *The Common Law*

Under common law, a fraud occurs when a person intentionally misrepresents a material fact that is justifiably relied on by another person to his or her detriment.³⁰⁶ Although an affirmative misstatement is generally required for a plaintiff to aver fraud,³⁰⁷ courts have recognized a number of circumstances under which a defendant's "pure silence" may also constitute fraudulent conduct. One such circumstance occurs in transactions where the defendant is under a duty to disclose material information "because of a fiduciary or other similar relation of trust and confidence . . ."³⁰⁸ Indeed, the classical theory of insider trading liability is premised precisely on this exception to the general rule of *caveat emptor*.³⁰⁹

Nondisclosure by a fiduciary, however, constitutes only one of many well-recognized categorical exceptions to the rule that silence in a business transaction is generally not fraudulent.³¹⁰ Other situations where an affirmative duty to

³⁰⁵ See *Basic, Inc. v. Levinson*, 485 U.S. 224, 253 (1988) (White, J., concurring in part and dissenting in part) (emphasizing that "[i]n general, the case law developed in this Court with respect to § 10(b) and Rule 10b-5 has been based on doctrines with which we, as judges, are familiar: common-law doctrines of fraud and deceit"); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975) (stating that "[i]n considering the policy underlying [the purchaser/seller standing requirements for actions under Rule 10b-5], it is not inappropriate to advert briefly to the tort of misrepresentation and deceit, to which a claim under Rule 10b-5 certainly has some relationship"); see also *Chiarella v. United States*, 445 U.S. 222, 234-35 ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

³⁰⁶ See RESTATEMENT (SECOND) OF TORTS § 525 (1976) (to be liable for fraud under tort law, the plaintiff must prove that the defendant: "fraudulently [made] a misrepresentation of fact, opinion, intention or law for the purpose of inducing [the plaintiff] to act . . . upon it . . . [causing] pecuniary loss . . . by his justifiable reliance upon the misrepresentation"); see also W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS 736-37 (1984) (discussing actions for fraud and deceit at common law).

³⁰⁷ See KEETON ET AL., *supra* note 306, at 737.

³⁰⁸ RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

³⁰⁹ See *supra* notes 36-37 and accompanying text (discussing *Chiarella's* recognition of a disclosure duty based on the relationship of trust and confidence between corporate insiders and shareholders).

³¹⁰ On this point, Justice Powell's dicta in *Chiarella* is somewhat misleading because his language could suggest that a duty to disclose may arise only where there is a pre-existing

speaking may arise include: (1) when one party actively conceals information from another party; (2) when one party's prior once-true statement is now incorrect due to changed circumstances; (3) when one party makes a half-true or ambiguous statement; and (4) when one party has superior knowledge or special facts that the other party cannot obtain.³¹¹ Because insider trading cases premised on the misappropriation theory involve the use of unlawfully obtained information, this latter category—superior, but unobtainable, knowledge—is clearly the exception most relevant to analyzing whether a person who traded on the basis of misappropriated information owes a disclosure duty to the investors with whom he trades. To be sure, those investors trading contemporaneously in the market with the misappropriator lack access to valuable information that, if known, would negate their willingness to conclude the transaction at the undervalued or overvalued market price.

Under common law, courts have recognized disclosure duties in a wide array of business transactions where one party could not have obtained the superior knowledge or special facts possessed by the other party.³¹² One such situation involves instances where the informational advantage was acquired through

fiduciary relationship. See *supra* notes 36–37 and accompanying text (discussing *Chiarella's* recitation of the common law). As Professor Langevoort has pointed out, “the Court’s principal citation for its conclusion is RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976), which lists a number of common law bases for compelling affirmative disclosure in addition to the existence of a fiduciary relationship” Langevoort, *supra* note 18, at 12 n.44; see also Anderson, *supra* note 18, at 351 (noting that while “the Court appeared to be determined in *Chiarella* to incorporate the common law of misrepresentation wholesale into the securities laws, it did not acknowledge that, under the modern law of misrepresentation, the existence of a duty to disclose is not limited to situations involving pre-existing fiduciary relationships”); Scheppele, *supra* note 225, at 131 (maintaining that “despite Justice Powell’s claim that the common law bolsters his argument about the obligation to disclose information, equitable rules invoked by common law courts never supported such a narrow view of the duty in other sorts of transactions”).

³¹¹ See KEETON ET AL., *supra* note 306, at 737–40; see also Nicola W. Palmieri, *Good Faith Disclosures Required During Precontractual Negotiations*, 24 SETON HALL L. REV. 70, 120–41 (1993) (discussing a host of circumstances under which the general rule permitting silence is not applicable); Fleming James, Jr. & Oscar S. Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 523–27 (1978) (same).

³¹² In his *Chiarella* dissent, Justice Blackmun set out to prove precisely this contention. See *Chiarella v. United States*, 445 U.S. 222, 245–49 (1980) (Blackmun, J., dissenting) (citing cases and noting that courts applying common law have taken steps “toward application of the ‘special facts’ doctrine in a broader array of contexts where one party’s superior knowledge of essential facts renders a transaction without disclosure inherently unfair”); see also *infra* notes 326–28 and accompanying text (discussing the RESTATEMENT (SECOND) OF TORTS and the RESTATEMENT (SECOND) OF CONTRACTS as well as trends in recent case law on fraud and misrepresentation).

wrongful or illegal actions.³¹³

The idea that a party to a business transaction possesses a duty to disclose information acquired by a wrongful act can be traced to the case of *Phillips v. Homfray*,³¹⁴ decided by an English court in 1871. The defendant-purchasers in the case trespassed upon the plaintiff-vendor's land, acquired coal from underneath it, and tested the coal for value prior to agreeing to purchase the land. The vendors, not knowing the true value of the land, then sold the land to the defendants at an undervalued price. The court refused to order specific performance of the contract, reasoning that it "is not merely that the purchasers, being more experienced men, knew the value of the coal better than the vendors, but that the vendors being unable to gain access to the coal, the purchasers *took advantage of an unlawful access to it* in order to test its value, and did not communicate to the vendors the result."³¹⁵ The court therefore maintained that the general rule of *caveat emptor* (or in this case *caveat vendor*) would only be applied in those instances where the party with the informational advantaged party employed a "legitimate mode of acquiring knowledge."³¹⁶

The holding in *Homfray* was embraced by the drafters of the Restatement (Second) of Contracts,³¹⁷ and, just recently, it was echoed by the Supreme Court of Colorado in *Mallon Oil Co. v. Bowen/Edwards Association*.³¹⁸ Indeed, the

³¹³ See John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1363 (1981) (emphasizing that while "the common law tolerated exploitation of many informational advantages, it never condoned informational advantages obtained by a tortious or illegal act, but denied to the wrongdoer the fruits of his wrongdoing even if he otherwise would have been permitted to exploit the type of informational advantage at issue"); see also *infra* notes 314–25 and accompanying text (discussing exception to general rule in cases where superior knowledge or special facts are unlawfully obtained).

³¹⁴ 6 Ch. App. 770 (1871) (discussed in Keeton, *supra* note 56, at 25–26).

³¹⁵ *Id.* at 779–80 (emphasis added).

³¹⁶ *Id.* at 780. The *Homfray* court hypothesized an additional instance where an unlawfully obtained informational advantage would trigger a disclosure duty:

Suppose a picture-dealer, employed to clean a picture, scrapes off a part of the picture to see if he can discover a mark which will tell him who is the artist, and thus finds a mark showing it to be the work of a great artist; that would not be a legitimate mode of acquiring knowledge for the purpose of enabling him to buy the picture at a lower price than the owner would have sold it for had he known it to be the work of that artist.

Id.

³¹⁷ See RESTATEMENT (SECOND) OF CONTRACTS § 161 illus. 11 (1979) ("[Buyer] A learns of the valuable mineral deposits from trespassing on [vendor] B's land . . . A's non-disclosure is equivalent to an assertion that the land does not contain valuable mineral deposits, and this assertion is a misrepresentation.").

³¹⁸ 965 P.2d 105 (Colo. 1998). The case involved a vendor of oil and gas exploration

Mallon Oil court was explicit in recognizing that “[a]t common law, the general rule is that a person rightfully on property does not have a duty to disclose knowledge of the land to a seller of the land who does not have the same knowledge.”³¹⁹ However, citing the Restatement (Second) of Contracts, the court maintained that “this rule does not apply when the buyer acquires the information through improper means, such as a trespass.”³²⁰

Although cases paralleling the facts of *Homfray* and *Mallon Oil* are rarely litigated under common law doctrines of fraud and deceit,³²¹ renowned scholars in tort and contracts law have nonetheless contended that *Homfray*'s recognition of a duty to disclose unlawfully obtained information is an accurate statement of

rights on Native American tribal land who had sought to recover damages from the defendant-corporation that purchased those rights. The vendor claimed that the corporation committed fraud when it failed to disclose in the course of the transaction that the tribal lands contained methane gas—a fact that made the rights far more valuable than the negotiated price. *See id.* at 107–09. The plaintiff-vendor contended that the corporation was under a duty to disclose its finding of gas because the corporation's agent had “trespassed” upon Mallon's exclusive right to exploration. That is, the vendor-plaintiff argued that the general rule of *caveat emptor* did not apply because the defendant-corporation's superior knowledge regarding the methane gas was obtained illegally. *See id.* at 108. Although the court agreed as a matter of law with the plaintiff's contention that the defendant-corporation would have had a duty to disclose if the information had been obtained unlawfully, the court accepted the lower courts' factual finding that the defendant's agent was rightfully on the land and therefore was not a geophysical trespasser. *See id.* at 111–12; *see also* *Mallon Oil Co. v. Bowen/Edwards Assoc.*, 940 P.2d 1055, 1061 (Colo. Ct. App. 1996) (stating that “because [the defendant's agent] was rightfully on the land looking for coal, he was not a geophysical trespasser, and consequently, defendants had no duty to disclose their discovery of gas”).

³¹⁹ *Mallon Oil Co.*, 965 P.2d at 111 (citing W.L. SUMMERS, *THE LAW OF OIL & GAS* § 662 (1962)).

³²⁰ *Id.* at 112 (citing RESTATEMENT (SECOND) OF CONTRACTS § 161 illus. 11 (1981)).

³²¹ Cases involving the fraudulent use of stolen information are often brought privately under trade secret laws, *see supra* note 156, or prosecuted under the federal mail fraud or wire fraud statutes codified at 18 U.S.C. §§ 1341, 1343 (1994). *See, e.g.*, *United States v. Kent*, 608 F.2d 542 (5th Cir. 1979) (mail fraud statute violated where defendant bribed a company's employee to release geological data and other confidential company information and then subsequently sold this misappropriated information to a third party who, in turn, used the information to obtain valuable leases); *Abbott v. United States*, 239 F.2d 310 (5th Cir. 1956) (mail fraud statute violated where defendant bribed company employee to furnish him with employer's copies of geophysical maps to facilitate scheme to acquire property at low cost); *see also* *United States v. Cherif*, No. 89-CR-450, 1989 WL 112769, at *4 (N.D. Ill. Sept. 19, 1989) (noting that the federal mail and wire fraud statutes “reach breaches of fundamental concepts of fair dealing which society condemns as fraudulent” and stating that “[i]t takes no cognoscente of paperback westerns or grade B movies to know that someone who holds up the stage to find out where the railroad is coming through, and then, armed with that information, buys the widow's ranch for a pittance, should and will be brought to justice by the conclusion”).

common law. For instance, in what has been described as “the most influential article” on nondisclosure,³²² Dean Page Keeton cited *Homfray* and concluded that “[a]ny time information is acquired by an illegal act . . . there should be a duty to disclose that information”³²³ Professors Bower and Turner have expressed a similar conclusion stating that “suppression by a purchaser of facts affecting the value of the property which are not merely within his own knowledge, but the issue of his own volition and wrongful action, is equivalent to a misrepresentation.”³²⁴ Significantly, none of these commentators appear to limit the duty to disclose wrongfully acquired information to circumstances where the unlawful acts of misappropriation were perpetrated against the other party to the business transaction.³²⁵

It is also important to recognize that both the Restatement (Second) of Torts and the Restatement (Second) of Contracts adopt an even broader approach than the courts in *Homfray* and *Mallon Oil* to the question of whether one party’s superior, but unobtainable, knowledge triggers a duty to disclose to the other party in a business transaction. For example, Section 551(2)(e) of the Restatement (Second) of Torts imposes a duty to disclose “facts basic to the transaction” when one party to a business transaction “knows that the other is about to enter into it under a mistake as to [those facts], and that the other, because of the relationship between them, the customs of the trade or other

³²² See Palmieri, *supra* note 311, at 174 (characterizing Professor Keeton’s article cited in *supra* note 56).

³²³ Keeton, *supra* note 56, at 25–26; see also KEETON ET AL., *supra* note 306, at 739 (information acquired by an illegal act “makes a difference on the ethical equality of nondisclosure”).

³²⁴ GEORGE SPENCER BOWER & SIR ALEXANDER KINGCOME TURNER, *THE LAW OF ACTIONABLE MISREPRESENTATION* 107 (3d ed. 1974).

³²⁵ See *id.* at 107; Keeton, *supra* note 56, at 25–26. Moreover, although both *Mallon Oil* and *Homfray* involved situations where the superior information was allegedly misappropriated by one party to the transaction from the other transacting party, neither court appeared to limit the duty to disclose unlawfully obtained information to cases where the misappropriator was transacting business with the party whose information was unlawfully obtained. See *Mallon Oil Co. v. Bowen/Edwards Assoc.*, 965 P.2d 105, 111–12 (Colo. 1998) (phrasing the exception in broad-based terms); *Phillips v. Homfray*, 6 Ch. App. 770, 780 (1871) (same); see also *Cherif*, 1989 WL 112769, at *3 (hypothesizing fraud in a situation where a widow’s ranch was purchased “for a pittance” by someone who obtained superior information regarding its value through illegal actions *vis-à-vis* a third party). But see Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1331 (1998) (contending that “[o]utside of the context of the 1934 Act, a definition of fraud by silence based on misappropriation would run into the apparently intractable remedy problem. To give the ignorant trader a cause of action based on the knowledgeable trader’s commission of a tort against a complete stranger to the plaintiff is unthinkable in a world that still recognizes concepts of privity.”).

objective circumstances, would reasonably expect a disclosure of those facts.”³²⁶ Section 161(b) of the Restatement (Second) of Contracts contains a similar provision,³²⁷ and the commentary to both Restatements emphasizes that, in some circumstances, modern business ethics has created a reliance on the “good faith” and “common honesty” of the parties.³²⁸ Thus, the disclosure duty recognized more than a century ago in *Homfray* today constitutes only the tip of the iceberg.³²⁹ That is, although using unlawfully obtained information in a business transaction amounts to quintessential bad faith and unfair dealing, modern courts are willing to recognize disclosure duties in a variety of less egregious situations where one party to a business transaction possesses superior knowledge while the other party acts on a mistaken belief.³³⁰

³²⁶ RESTATEMENT (SECOND) OF TORTS § 551(2)(e) (1977).

³²⁷ Section 161(b) of the RESTATEMENT (SECOND) OF CONTRACTS states that:

A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist . . . where he knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.

RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1979).

³²⁸ See RESTATEMENT (SECOND) OF TORTS § 551 cmt. 1:

[T]here are situations in which the defendant not only knows that his bargaining adversary is acting under a mistake basic to the transaction, but also knows that the adversary, by reason of the relation between them, the customs of the trade or other objective circumstances, is reasonably relying upon a disclosure of the unrevealed fact if it exists. In this type of case good faith and fair dealing may require a disclosure.

Id.; Restatement (SECOND) OF CONTRACTS § 161 cmt. d (stating that a party “is expected . . . to act in good faith and in accordance with reasonable standards of fair dealing, as reflected in prevailing business ethics”).

³²⁹ See *Brass v. American Film Technologies*, 987 F.2d 142, 151–52 (2d Cir. 1993) (contending that “[i]t is no longer acceptable, if it ever was, to conclude in knowing silence, a transaction damaging to a party who is mistaken about its basic factual assumptions when . . . he would reasonably expect a disclosure”) (citing *Gaines Serv. Leasing Corp. v. Carmel Plastic Corp.*, 105 Misc. 2d 694, 697 (N.Y. Civ. Ct. 1980)); see also *id.* (noting that “New York has joined other jurisdictions in limiting the ‘privilege to take advantage of ignorance’” (quoting RESTATEMENT (SECOND) OF TORTS § 551 cmt. 1)).

³³⁰ See Deborah A. DeMott, *Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions*, 19 DEL. J. CORP. L. 65 (1994) (discussing cases where courts have imposed disclosure duties in arm's-length transactions and arguing that these nondisclosure cases cannot be rationalized by a single unifying theme); Palmieri, *supra* note 311, at 130–34 (discussing recent cases and concluding that “the superior knowledge or special facts doctrine is being used to chip away at caveat emptor even in arm's length transactions”);

In addition to serving the common law's goal of preventing one party's unjust enrichment at the expense of another party, prohibiting the use in business transactions of information that was obtained by unlawful or wrongful acts is also consistent with the common law's regard for economic efficiency.³³¹ As one scholar has noted:

[A] privilege to exploit information improperly obtained would reduce the incentive to invest in legitimate information production by exacerbating free rider problems and by placing on producers the risk of misappropriation. Less information would be produced, because at least some producers would shift resources from additional production to theft of what others have produced.³³²

It was the work of Professor (now Dean) Anthony Kronman³³³ that placed concerns of economic efficiency at the core of the common law's exceptions to the general rule that informational advantages may be exploited in business transactions without triggering liability for fraud.³³⁴ Professor Kronman points

Susan Rogers Finneran, *Knowing Silence of Nonentrepreneurial Information is Not Sporting*, 59 ALB. L. REV. 511, 553–55 (1995) (discussing cases and concluding that “[s]ilently withholding . . . nonentrepreneurial information is not ‘mere silence’ within the bargaining context; it is an assertion”); Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE W. RES. L. REV. 329, 386 (1991) (discussing cases and contending that “a general theory [of nondisclosure] can only succeed when it is recognized that there are discrete types of both nondisclosure transactions and arguments, and that each type must be evaluated separately with the broader theory”); *see also* Anderson, *supra* note 18, at 352 (contending that “[t]he important characteristic of [modern misrepresentation] cases is not that they have created a new duty to disclose termite infestation in real estate transactions, but that they illustrate that the modern law of misrepresentation has evolved in response to changing expectations about consumer protection and proper and improper bargaining tactics”); Langevoort, *supra* note 16, at 871 (emphasizing that “[t]oday, law books are filled with decisions imposing an affirmative disclosure obligation on people engaged in business negotiations”).

³³¹ *See* Barry, *supra* note 313, at 1364.

³³² *Id.*

³³³ *See* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 9 (1978). Professor Kronman's article has been described as “groundbreaking,” *see* Wonnell, *supra* note 330, at 340. It is also of some significance that the SEC relied on Professor Kronman's article to support its argument as *amicus* in *Moss v. Morgan Stanley Inc.* that the common law recognized a duty of disclosure in instances where the informational advantage was obtained through misappropriation or other unlawful acts. *See* Brief of the SEC, *supra* note 91, at 17 n.14 (citing Kronman, *supra*, at 9, 34).

³³⁴ At the outset of his article, Professor Kronman drew attention to Dean Keeton's recognition that, in deciding when to impose a duty to disclose superior information, courts often look to the way in which the information was acquired. *See* Kronman, *supra* note 333, at 11 n.32 (citing Keeton, *supra* note 56). Professor Kronman then stated that “[t]he main purpose

out, for example, that cases applying the rule of *caveat emptor* generally arise in situations where the party charged with nondisclosure has obtained the information through legitimate research or other bona fide economic activity.³³⁵ Thus, in these situations nondisclosure is permitted to preserve incentives for socially useful behavior.³³⁶ He then contrasts these cases to situations where the knowledgeable party's superior informational advantage is not the result of a deliberate search and where diligence on the part of the ignorant party could not have uncovered the undisclosed information.³³⁷ In these cases of unilateral mistake, "a rule requiring him to disclose what he knows will not cause him to alter his behavior in such a way that the production of information of this sort will be reduced."³³⁸

The common law's reluctance to reward individuals for bad faith and dishonesty, coupled with its regard for economic efficiency, provides a very compelling case for why trading securities on the basis of misappropriated information should be viewed as a fraud against the investors with whom the misappropriator trades. Like the land purchaser whose informational advantage was obtained through a trespass, the misappropriator gains his transactional advantage only through unlawful means. And in such an instance, the general rule of *caveat emptor* is no longer applicable because the misappropriator is clearly operating in bad faith.³³⁹ Moreover, because a misappropriator's conduct "quite clearly serves no useful function except his own enrichment at the expense of others,"³⁴⁰ there are few costs associated with imposing a disclosure

of the present article is to develop this distinction between different kinds of information in a more rigorous fashion, to justify the distinction on economic grounds, and to demonstrate its explanatory power as a principle for ordering the disclosure cases." *Id.* at 11 n.32.

³³⁵ *See id.* at 19–27; *see also id.* at 18 (stating that "[t]he cases permitting nondisclosure . . . involve information which, on the whole, is likely to have been deliberately produced").

³³⁶ *See id.* at 19–27; *see also id.* at 2 (contending that "a legal privilege of nondisclosure is in effect a property right [and] . . . where special knowledge or information is the fruit of a deliberate search the assignment of a property right of this sort is required in order to ensure production of information at a socially desirable level").

³³⁷ *See id.* at 18–27.

³³⁸ *Id.* at 32.

³³⁹ A duty to disclose or abstain from trading misappropriated information is particularly warranted because, as other securities scholars have pointed out, the SEC's "elaborate public reporting system has created an expectation that material information is generally accessible, and . . . investors have no opportunity to inquire of one another as to the possible use or possession of nonpublic information." Cox & Forgarty, *supra* note 257, at 359 (citing Brudney, *supra* note 23, at 326–27).

³⁴⁰ *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting).

obligation.³⁴¹

Thus, under the common law, O'Hagan could be said to have committed two frauds: (1) he defrauded Dorsey & Whitney and Grand Met by remaining silent while using their information to trade securities for personal profit; and (2) he defrauded the investors who sold options and stock in Pillsbury by remaining silent in the face of ill-gotten facts indicating that the Pillsbury securities he was purchasing were undervalued significantly. Yet, although the Court recognized that O'Hagan had harmed *both* the source of the information *and* investors in the marketplace, the Court was prepared to characterize only the former harm as a "fraud."

2. Section 10(b) and Rule 10b-5

The conclusion that securities investors are deceived and defrauded by a person trading on misappropriated information is not only supported by a fair reading of the common law, but it is also consistent with Section 10(b)'s statutory language and with prior Supreme Court precedents interpreting that language. This conclusion is further supported by Congress's determination in ITSFEA to amend the Exchange Act with the addition of Section 20A.

It goes almost without saying that the text of Section 10(b) is written expansively, prohibiting "any person . . . in connection with the purchase or sale of any security" from using or employing "any manipulative or deceptive device or contrivance in contravention of" SEC rules.³⁴² Rule 10b-5, phrased in equally expansive language, renders it unlawful "[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."³⁴³ As the Supreme Court recognized many years ago, "[t]hese proscriptions, by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive."³⁴⁴

Although neither Section 10(b) nor Rule 10b-5 state explicitly whether

³⁴¹ See Seligman, *supra* note 18, at 1092 n.49 ("If traders could exploit material nonpublic information by improperly obtaining it, rather than searching for it, they will reduce their investment in information production. Ultimately, less information will be produced and a less desirable allocation of resources will occur than if traders only had an incentive to search legitimately for new information about material changes in market conditions.").

³⁴² 15 U.S.C. § 78j(b) (1994).

³⁴³ 17 C.F.R. § 240.10b-5(c) (1996).

³⁴⁴ *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972); *see also id.* at 151 (noting 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'") (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963)).

silence constitutes a fraudulent or deceptive device, the Supreme Court made clear in *Chiarella* that courts should look to the common law to determine when “silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b).”³⁴⁵ Thus, because the common law recognizes fraud in cases where a party to a business transaction fails to disclose material information that was obtained through unlawful means,³⁴⁶ the text of Section 10(b) and Rule 10b-5 may be read to prohibit such conduct, provided that the nondisclosure occurs “in connection” with the purchase or sale of any security.³⁴⁷

Moreover, to the extent that Congress intended Section 10(b)'s text to alter the common law, it intended that provision and the SEC rules promulgated thereunder to provide greater, not lesser, protection for investors and the securities markets.³⁴⁸ Indeed, as the Supreme Court has observed on multiple occasions, “the 1934 Act and its companion legislative enactments embrace a ‘fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry.”³⁴⁹ In particular, Congress sought to prohibit “those manipulative and deceptive practices which have been demonstrated to fulfill no useful function”³⁵⁰ and to “assure that dealing in securities is fair and

³⁴⁵ *Chiarella*, 445 U.S. at 230.

³⁴⁶ *See supra* Part IV.A.1.

³⁴⁷ *See infra* notes 365–67 and accompanying text (contending that the “fraud on investors” misappropriation theory is well suited to satisfying Section 10(b)'s “in connection with” requirement because the theory posits that the defendant is deceiving and defrauding the actual purchasers or sellers of securities).

³⁴⁸ *See Basic, Inc. v. Levinson*, 485 U.S. 224, 244 n.22 (1988) (stating that “[a]ctions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims, and are in part designed to add to the protections provided investors by the common law”) (citations omitted); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (stating that “[a]n important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry”); *see also Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (stating that the Court has “eschewed rigid common-law barriers in construing the securities laws”).

³⁴⁹ *Affiliated Ute*, 406 U.S. at 151 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)).

³⁵⁰ S. REP. NO. 73-792, at 6 (1934); *see also Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (emphasizing that because “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”) (citations omitted).

without undue preferences or advantages among investors."³⁵¹ Where a person obtains his informational advantage in a securities transaction through misappropriation, imposition of a duty under Section 10(b) and Rule 10b-5 to abstain or disclose to investors falls squarely within these broad congressional purposes.³⁵²

To be sure, in the specific context of insider trading, the Court has used similar policy justifications to justify reading the text of Section 10(b) and Rule 10b-5 beyond the limits imposed by common law. For example, as noted earlier, the *Chiarella* Court's classical theory of insider trading predicated liability on a traditional insider's failure to disclose material information to the shareholders with whom he was trading, even though the majority of courts at common law did not recognize a fiduciary relationship between insiders and shareholders, and most certainly did not recognize duties of disclosure in market transactions, such as those conducted on a stock exchange.³⁵³ Moreover, the *Chiarella* Court expanded upon the common law when it read Section 10(b) and Rule 10b-5 to require insiders to disclose or abstain in transactions with *prospective* shareholders of the corporation, on the theory that "it would be a sorry

³⁵¹ H.R. CONG. REP. NO. 94-229, at 91 (1976), *reprinted in* 1975 U.S.C.C.A.N. 323.

³⁵² Prior to *O'Hagan*, many scholars questioned the value of emphasizing Supreme Court statements made in Section 10(b) cases decided prior to the mid-1970s, when the Court in a series of "retrenchment" cases, *see supra* note 115, began to narrow its reading of the protections available under federal securities law in general, and Section 10(b) in particular. *See* Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. Rev. 691, 713 n.99 (1997) (acknowledging that "the current Supreme Court is not likely to stress [the broad holdings in *Affiliated Ute*, *Bankers Life*, and *Capital Gains*] but to respond that 'generalized references' to the securities laws' 'remedial purposes' are not enough justification to construe a securities statute liberally") (quoting *Aaron v. SEC*, 446 U.S. 680, 695 (1980)); *see also* William E. Donnelley & Thomas J. McGonigle, *Ringing Endorsement of the Misappropriation Theory Sets Stage for Wide-Ranging Prosecution of Insider Trading*, LEGAL TIMES, July 14, 1997, at 550 (contending that the Government's decision to seek certiorari in *O'Hagan* was risky because "[f]or the past 20 years, the Supreme Court has been generally unreceptive to many of the SEC's more expansive, policy-oriented interpretations of the federal securities laws" and emphasizing that "the Court has insisted upon confining the scope of Section 10(b) within the narrower limits that the Court concluded were dictated by the language of the statute"). Yet, as Dean Seligman has recently maintained, Justice Ginsburg's *O'Hagan* opinion "adopted an earlier mode of analysis when she relied on a more generic legislative purpose for the entire Act." Seligman, *supra* note 142, at 18. Support for a broader, more flexible reading of the text of Section 10(b) and Rule 10b-5 can therefore be drawn from *O'Hagan* itself. *See infra* notes 393-97 and accompanying text; *see also* Richard H. Walker & David M. Levine, *The Limits of Central Bank's Textualist Approach*, 26 HOFSTRA L. REV. 1, 21 (1997) (highlighting the "broad policy considerations" undertaken in *O'Hagan* and contending that *O'Hagan* establishes that "textualism does not require literalism").

³⁵³ *See supra* note 37.

distinction" to regulate insider buying but not selling.³⁵⁴ In doing so, the Court necessarily recognized that an insider can violate the Exchange Act even if he owes no traditional fiduciary duty to the investor with whom he is trading.

The Supreme Court's holding in *Dirks* also adopted a flexible reading of the statutory text when it held that a tippee's silence in trading securities based on material, nonpublic information could be construed as fraudulent under Section 10(b) and Rule 10b-5, even though the tippee was a stranger who owed no independent fiduciary duties to the shareholders of the corporation whose stock he was trading.³⁵⁵ Indeed, it was policy, rather than any precedent in common law, that prompted the Court to conclude that "some tippees must assume an insider's [fiduciary] duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*."³⁵⁶ This language from *Dirks* is particularly significant because it demonstrates that the question of whether there is a duty to disclose under Section 10(b) and Rule 10b-5 may require, in certain circumstances, an analysis as to how the material, nonpublic information was obtained. It also demonstrates that one's status as a stranger to the investors with whom one is trading does not necessarily foreclose liability for trading based on material, nonpublic information.³⁵⁷ If Section 10(b) and Rule 10b-5 are broad enough to impose a purported fiduciary obligation on the part of an outsider whose informational advantage was the product of an insider's improper tip, then these provisions can certainly be read to trigger a specific disclosure obligation on the part of a person who *improperly* obtains his informational advantage through an unlawful misappropriation.

Finally, recognition that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading"³⁵⁸ also fits within Congress's own interpretations of Section 10(b) and Rule 10b-5, particularly those statements in the legislative history of ITSFEA explaining Section 20A's express private right of action for contemporaneous traders.³⁵⁹ Recall that Congress codified this express right of action specifically to overturn the result in *Moss v. Morgan Stanley Inc.*, where the Second Circuit

³⁵⁴ See *Chiarella v. United States*, 445 U.S. 222, 227 n.8 (1980).

³⁵⁵ See *supra* notes 9, 41–48 and accompanying text.

³⁵⁶ *Dirks v. SEC*, 463 U.S. 646, 660 (1983).

³⁵⁷ See *Langevoort*, *supra* note 18, at 28 (contending that the Court's endorsement of tippee liability "is an indication that it will not adhere strictly to the idea that only fiduciaries are obligated to make disclosures when trading").

³⁵⁸ *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

³⁵⁹ See *supra* notes 293–95 and accompanying text; see also Steve Thel, *Statutory Findings and Insider Trading Regulation*, 50 VAND. L. REV. 1091, 1108 & n.80, 1111–15 (1997).

refused to recognize that a private plaintiff was deceived by the defendants' purchases of stock based on misappropriated information concerning an imminent tender offer.³⁶⁰ As Professor Langevoort has previously concluded, Section 20A "as a practical matter, codifies the notion espoused by Chief Justice Burger in his *Chiarella* dissent [that] persons who misappropriate owe by virtue of that fact an affirmative duty of disclosure to the marketplace."³⁶¹

B. *The Superiority of a "Fraud on Investors" Approach*

Reframing the misappropriation theory to emphasize the fraud that is perpetrated on the investors with whom a misappropriator trades is not only a viable approach to insider trading liability under Section 10(b) and Rule 10b-5, but, for a number of reasons, it is also an approach that is far superior to the "fraud on the source" misappropriation theory that was endorsed in *O'Hagan*.

First, the "fraud on investors" theory is better suited to meeting both the "deception" and "in connection with" requirements specified by the text of Section 10(b) and Rule 10b-5. Indeed, because the investors with whom a misappropriator trades are the persons deceived within the meaning of these provisions, the misappropriation theory would no longer be constrained to cases fitting *O'Hagan's* "deception by a fiduciary" paradigm. Thus, although computer hackers, "mere" thieves, and brazen fiduciaries would all escape liability for trading based on misappropriated information under *O'Hagan's* theory,³⁶² the broader "fraud on investors" version would hold accountable all of these persons under Section 10(b) and Rule 10b-5 for *deceiving investors* in connection with a securities transaction. Similarly, the "fraud on investors" theory eliminates potential problems with satisfying the "in connection with" requirement in future misappropriation cases that may involve factual scenarios more complex than the one at issue in *O'Hagan*.³⁶³ Under this alternative, the timing of the fiduciary's breach of duty to the source of the information does not have to "coincide" with the securities transaction because the fraud that is proscribed under Section 10(b) and Rule 10b-5 occurs when the defendant purchases or sells securities without disclosing his unlawfully obtained informational advantage to the other parties to the transaction. Any difficulties that may be faced in future prosecutions of tipper/tippee misappropriation cases

³⁶⁰ See *supra* notes 88–96 and accompanying text.

³⁶¹ LANGEVOORT, *supra* note 18, at 9-19; see also Mitchell, *supra* note 18, at 778 (contending that the "ITSFEA may have implicitly overruled, or at least severely limited, the Supreme Court's seminal decision in *Chiarella v. United States* and the jurisprudential approach it espoused") (citation omitted).

³⁶² See *supra* Part III.A.1–2.

³⁶³ See *supra* Part III.A.3.

under the “fraud on the source” theory³⁶⁴ would therefore be avoided under the alternative “fraud on investors” theory.

Along that same vein, the “fraud on investors” theory also satisfies the principal criticism raised by the three dissenting Justices in *O'Hagan*: that the *O'Hagan* majority misinterpreted Section 10(b) and Rule 10b-5 by failing to read the “in connection with” element to “require the manipulation or deception of a party to a securities transaction.”³⁶⁵ Unlike the “fraud on the source” theory endorsed in *O'Hagan*, the “fraud on investors” version necessarily satisfies this more exacting interpretation of the “in connection with” requirement because the proscribed fraud has a direct impact on the integrity of the defendant’s securities transaction.³⁶⁶ Thus, had the majority endorsed the broader “fraud on investors” version of the misappropriation theory, the arguments of the *O'Hagan* dissenters would have been the ones in need of reframing.³⁶⁷

In addition to these doctrinal advantages, restructuring the misappropriation theory of insider trading to center around the fraud that is perpetrated on investors eliminates the criticism that the “fraud on the source” theory is merely a pretext for enforcing the parity of information approach that the Court rejected in *Chiarella* and *Dirks*.³⁶⁸ Indeed, a misappropriation theory that emphasizes fraud on investors reconnects the specific conduct prohibited by the terms of

³⁶⁴ See *id.*

³⁶⁵ *United States v. O'Hagan*, 117 S. Ct. 2199, 2220 (1997) (Scalia, J., concurring in the judgment in part and dissenting in part); see *supra* notes 135–41 and accompanying text for a discussion of Justice Thomas’s opinion (in which Chief Justice Rehnquist joined) and *supra* notes 133–34 and accompanying text for a discussion of Justice Scalia’s opinion.

³⁶⁶ Justices Thomas and Scalia, and Chief Justice Rehnquist would appear to endorse the view expressed almost fifteen years ago by Judge Henry Friendly in *Chemical Bank v. Arthur Anderson & Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 469 U.S. 884 (1984). Judge Friendly stated that:

The purpose of § 10(b) and Rule 10b-5 is to protect persons who are deceived *in securities transactions*—to make sure that buyers of securities get what they think they are getting and that sellers of securities are not tricked into parting with something for a price known to the buyer to be inadequate or for a consideration known to the buyer not to be what it purports to be.

Id. at 943 (emphasis added). The “fraud on investors” misappropriation theory is fully consistent with this view because the nondisclosure prohibited by Section 10(b) and Rule 10b-5 involves facts indicating that the securities will be worth far more (or less) in the future.

³⁶⁷ See BLOOMENTAL, *supra* note 151, at 1189–90 (stating that “[t]he Burger view [in *Chiarella*] avoids some of the anomalies noted by Justice Thomas in treating the fraudulent act committed on someone else as the basis for what otherwise would be nonfraudulent vis-à-vis the party with whom the misappropriator traded”).

³⁶⁸ See *supra* Part III.B.3.b.

Section 10(b) and Rule 10b-5 with the well recognized investor protection and market integrity goals of federal securities regulation.³⁶⁹ Thus, under this theory, trading on misappropriated information violates Section 10(b) and Rule 10b-5 because investors are deceived, and deceit practiced on investors is to be prohibited because “[d]efrauded investors are among the very individuals Congress sought to protect in the securities laws.”³⁷⁰ On the other hand, the

³⁶⁹ Shortly after *Chiarella*, Professor William Wang criticized Chief Justice Burger’s “fraud on investors” theory, maintaining that “[a] Rule 10b-5 duty to disclose to the party [trading with the misappropriator] would compound the misappropriation or breach of duty to the employer.” Wang, *supra* note 18, at 1273. But this observation is equally applicable to Rule 10b-5’s mandate, under the classical theory, that insiders in possession of material, nonpublic information must “disclose or abstain” from trading in the shares of the corporation. See *supra* notes 6–9 and accompanying text. Indeed, if the disclosure alternative to the “disclose or abstain” rule were exercised by insiders, the corporation’s shareholders would likely be worse off because the requisite disclosure would reveal confidential information that was being kept secret by the corporation for the good of all shareholders. This is undoubtedly why, under both the classical theory and the “fraud on investors” misappropriation theory, the duty owed to investors is phrased in the alternative: insiders, and persons who have misappropriated nonpublic information, have “an absolute duty to disclose that information or to refrain from trading.” *Chiarella v. United States*, 445 U.S. 222, 240 (1980). (Burger, C.J., dissenting) (emphasis added). Both “disclose or abstain” rules therefore effectively operate as a mandate for abstention because neither insiders nor misappropriators are likely to comply with the rule by disclosing confidential information to investors. In the case of insiders, such disclosure would breach their duty of loyalty owed to all shareholders; and in the case of misappropriators, such disclosure would reveal the misappropriation to the source. And in both cases, disclosure to investors in the market would eliminate the trader’s informational advantage (without which there would be no trading profits).

³⁷⁰ *Herman & MacLean v. Huddleston*, 459 U.S. 375, 390 (1983). Like the “fraud on the source” theory endorsed in *O’Hagan*, the broader “fraud on investors” theory would place on the Government the burden of proving that the material, nonpublic information used in the securities transaction was misappropriated from its source and that the defendant engaged in the securities transactions with scienter. Cf. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) (holding that “in the absence of any allegation of ‘scienter,’” no cause of action for damages will lie under Section 10(b) and Rule 10b-5). Ironically, under a “fraud on investors” misappropriation theory, the easier cases will be those involving securities trading by “mere thieves” because obtaining confidential information through theft, burglary, espionage, and the like is clearly unlawful, see, e.g., *supra* note 156 (discussing the computer hacker who misappropriates confidential commercial information), and proving scienter in a securities transaction based on information that was clearly stolen should not be difficult in the wake of judicial recognition that misappropriators of information have an absolute duty under Section 10(b) and Rule 10b-5 to disclose or abstain from trading. The most complicated cases, of course, will be those where the use of material, nonpublic information constitutes a misappropriation only because the use of such confidential information breaches a fiduciary duty to the source of the information (i.e., the physician-patient cases, the family relationship cases, etc.). See *supra* note 63.

Under either misappropriation theory, there will likely be litigation as to which pre-

theory does not reach as far as the parity of information approach because it recognizes that lawfully obtained informational advantages do not trigger a disclosure duty to the marketplace.³⁷¹ Viewing investors as the parties who are deceived and defrauded by a misappropriator's securities trading also reunites the illegal acts of nondisclosure with the standard of materiality that is actually used in misappropriation cases and thereby eliminates the anomaly that exists under current law.³⁷²

Finally, premising violations of Section 10(b) and Rule 10b-5 on the "fraud on investors" rather than the "fraud on the source" would rationalize the

existing relationships prohibit securities trading based on confidential information learned in the course of that relationship. *See* Coffee, *supra* note 226, at 5 (characterizing *O'Hagan* as ambiguous regarding the nature of the relationship that triggers an obligation to disclose to the source); Painter et al., *supra* note 142, at 188–200 (criticizing *O'Hagan* in part because "the full reach of the misappropriation theory is far from clear, particularly when applied to relationships not falling into one of the traditional categories of common law fiduciary duty"). Professors Painter, Krawiec, and Williams are particularly troubled by the *O'Hagan* Court's unwillingness to confront the constitutional due process implications involved in criminal cases where the theory is applied to purported misappropriations that take place in relationships that are not clearly fiduciary in nature. *See id.* at 196 (maintaining that "[t]his common law development of criminal standards arguably violates general canons governing judicial construction of criminal statutes and implicates due process considerations"). But re-characterizing the legal effect of a misappropriator's securities trading does nothing to change the Government's (admittedly, often difficult) burden of demonstrating that a misappropriation in fact occurred. Likewise, under either theory, if the Government carries its burden of establishing scienter, constitutional requirements of due process will be satisfied.

³⁷¹ Recognizing that *all* unearned informational advantages place investors at a trading disadvantage, *see* Brudney, *supra* note 23, at 357, some securities law scholars might argue that the "fraud on investors" misappropriation theory does not go far enough because Section 10(b) and Rule 10b-5 should be construed to prohibit *all* securities trading based on such informational advantages. *See* Brudney, *supra* note 24, at 256–59; *see also* Salbu, *supra* note 18, at 233 (contending that "misappropriation theory cannot insure market integrity because the focus on particular transactions fails to address the issue of information asymmetry"); Ronald F. Kidd, Note, *Insider Trading: The Misappropriation Theory Versus an "Access to Information" Perspective*, 18 DEL. J. CORP. L. 101, 118–36 (1993) (advocating Professor Brudney's parity of access approach to insider trading). Although a parity of information rule may engender even greater public confidence in the securities markets, the rule would come with costs that are too dear. Specifically, as the Court correctly recognized in *Dirks*, a parity of information approach might chill legitimate and socially useful investment behavior, such as diligent searches for information by investment analysts and other market participants. *See infra* text accompanying notes 383–84 (contending that a "fraud on investors" theory can be reconciled with *Dirks* because the theory only deters corporate theft of intangible property; it will not reduce incentives to legitimately search out information).

³⁷² *See supra* note 265 (pointing out that courts in "fraud on the source" cases generally assess materiality by considering whether a reasonable investor would consider the information significant).

misappropriation theory of insider trading with both congressional and judicial determinations as to who has standing to sue insider traders and tippers. In particular, Section 20A's express private right of action would make far more sense if contemporaneous traders with statutory standing to sue were actually the parties who were defrauded by the person who traded on the basis of the misappropriated information, or who tipped misappropriated information to a person who then traded.³⁷³

³⁷³ See *supra* notes 298–302 and accompanying text. In an *amicus curiae* brief supporting Respondent O'Hagan, several law professors urged the Court to reject the misappropriation theory, in part because “[u]ltimately, it is up to Congress to define the parameters of illegal trading, and the necessary correlation between a trading transaction and any third-party fiduciary relationship.” Law Professors-Respondent Brief, *supra* note 246, at 28. Other securities law scholars have previously highlighted the need for a statutory definition. See, e.g., Fisch, *supra* note 18, at 251 (contending that “Congress should replace the current regime with a statute that is clear and predictable”); Homer Kripke, *A Note on Insider Trading: An Example of How Not to Make Law*, 39 ALA. L. REV. 349, 349 (1988) (concluding that “legislation is now needed to straighten out the mess we call insider trading law”); Seligman, *supra* note 18, at 1090 (proposing that Congress enact a parity of information rule, which could be modified where necessary with limited exceptions by statutory amendment or SEC rulemaking). Yet, despite a number of serious attempts, Congress has not passed any legislation setting the parameters of insider trading liability in general, or Section 10(b) specifically (other than Section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b), which prohibits so-called “short swing” trading profits by a corporation’s officers, directors, and ten percent shareholders). For a comprehensive description of Congress’s attempts to define insider trading, see FERRARA ET AL., *supra* note 18, at Chapter IV. Indeed, Congress determined that “the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.” ITSFEA House Report, H.R. NO. 100-910, at 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6048. Congress’s contentment with the judicial development of insider trading law through the existing anti-fraud prohibition in Section 10(b) is further evidenced by its decision in ITSFEA, and its decision four years earlier in the Insider Trading Sanctions Act of 1984 (“ITSA”), Pub. L. No. 98-376, 98 Stat. 1264 (1984), to expand significantly the SEC’s enforcement arsenal in insider trading cases. See FERRARA ET AL., *supra* note 18, at §§ 4.03–4.05. With the Government’s victory in *O’Hagan*, a statutory definition of insider trading has never been less likely. See McLaughlin, *supra* note 161, at 1 (“By preserving an important part of the SEC’s enforcement program, the [*O’Hagan*] decision takes the pressure off Congress to enact legislation in this area.”); Swanson, *supra* note 142, at 1212 (contending that, after *O’Hagan*, “Congress lacks the impetus to define through legislation the parameters of insider trading liability”). Thus, because it was the judiciary that created the misappropriation theory, the task now once again falls on the judiciary to reframe the theory. Cf. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 292 (1993) (stating that “[t]he federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes”).

C. Reconciling a "Fraud on Investors" Theory with Chiarella, Dirks, and O'Hagan

What, if anything, stands in the way of a misappropriation theory that premises Section 10(b) and Rule 10b-5 liability on a trader's fraud on investors rather than on a trader's fraud on the source of the information? According to the Second Circuit in *Moss v. Morgan Stanley Inc.*,³⁷⁴ the Supreme Court's decision in *Chiarella* forecloses any possibility of a "fraud on investors" approach to insider trading liability.³⁷⁵ But *Moss's* reading of *Chiarella* cannot be correct because *Chiarella* expressly left open the question whether a person who purchases securities on the basis of misappropriated information owes a disclosure duty under Section 10(b) and Rule 10b-5 to the sellers of the securities.³⁷⁶ Moreover, *O'Hagan* clarifies the dicta in *Chiarella* that the Second Circuit in *Moss* misconstrued to bar any broader misappropriation theory. Indeed, as the *O'Hagan* majority correctly observed, "[t]he Court did not hold in *Chiarella* that the *only* relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders."³⁷⁷ Rather, *Chiarella* only foreclosed liability under the broad-based parity of information theory that previously had been endorsed by the Second Circuit.³⁷⁸ Thus, as the Court further noted in *O'Hagan*, any statements in *Chiarella* seeming to limit liability to deceptions by insiders to shareholders

³⁷⁴ 719 F.2d 5 (2d Cir. 1983), cert. denied, 465 U.S. 1025 (1984).

³⁷⁵ See *id.* at 12-16.

³⁷⁶ Noting that "four Justices found merit in it," the Court in *O'Hagan* observed that *Chiarella* "expressly left open the misappropriation theory before us today." *O'Hagan*, 117 S. Ct. at 2212. Here, however, Justice Ginsburg's opinion is confusing because, as noted above, the theory found meritorious by the four *Chiarella* Justices was Chief Justice Burger's misappropriation theory premised on "fraud on investors" rather than Justice Steven's version premised on the "fraud on the source." See *supra* notes 53-59 and accompanying text. Fortunately, a statement by the Court in *Chiarella* itself clarifies that *Chiarella* specifically reserved consideration of *both* misappropriation theories advanced by the Government. See *Chiarella*, 445 U.S. at 235-36 (acknowledging the argument in the Government's brief that *Chiarella's* misappropriation supports "a conviction under § 10(b) for fraud perpetrated upon *both* the acquiring corporation and the [securities] sellers" but concluding that "[w]e need not decide whether this theory has merit for it was not submitted to the jury") (emphasis added); see also *id.* at 243 n.4 (Burger, C.J., dissenting) (concluding that "the Court has not rejected the view, advanced above, that an absolute duty to disclose or refrain arises from the very act of misappropriating nonpublic information").

³⁷⁷ *O'Hagan*, 117 S. Ct. at 2212. In this regard, the *O'Hagan* majority's interpretation of *Chiarella* clearly differs from the interpretation espoused by Justice Powell in his Draft Dissent from the Denial of Certiorari for *Carpenter v. United States*. See *supra* note 70.

³⁷⁸ See *O'Hagan*, 117 S. Ct. at 2212.

were plainly statements “rejecting the notion that § 10(b) stretches so far as to impose ‘a general duty between all participants in market transactions to forgo actions based on material, nonpublic information’ and [should be confined] to that context.”³⁷⁹ Recognition of a specific disclosure duty under Section 10(b) and Rule 10b-5 in those particular cases where the nonpublic information used in the securities transaction was unlawfully misappropriated is a far cry from the parity of the information approach.

Does the Supreme Court’s decision in *Dirks v. SEC*³⁸⁰ stand in the way of a misappropriation theory that imposes Section 10(b) and Rule 10b-5 liability for a fraud on investors? Here, again, the answer is no. *Dirks* reinforced *Chiarella*’s core holding that the mere possession of material, nonpublic information in a securities transaction does not trigger a general duty of disclosure.³⁸¹ Moreover, in making the determination that *Dirks* did not violate Section 10(b) or Rule 10b-5, the Court expressly noted that *Dirks* was not under an obligation to keep the information confidential “[n]or did *Dirks* misappropriate or illegally obtain the information about Equity Funding.”³⁸² Significantly, the Court did not limit this statement to acts of misappropriation involving the breach of a fiduciary duty to the source of the information—nor could it, because *Dirks* had no pre-existing relationship of trust and confidence with either Secrist or Equity Funding (the sources of the material, nonpublic information with which his tippers traded). Thus, if *Dirks*’s misappropriation of information would have changed the result in the case, it necessarily would have been because he owed a disclosure duty

³⁷⁹ *Id.* (quoting *Chiarella*, 445 U.S. at 233).

³⁸⁰ 463 U.S. 646 (1983).

³⁸¹ See *id.* at 655; see also *O’Hagan*, 117 S. Ct. at 2212 (noting that *Dirks* “repeated the key point made in *Chiarella* [that there is] no ‘general duty between all participants in market transactions to forgo actions based on material, nonpublic information’”) (quoting *Chiarella*, 445 U.S. at 233). *O’Hagan*’s narrow construction of *Chiarella*’s dicta, see *supra* notes 377–79 and accompanying text, supports a similarly narrow reading of the dicta in *Dirks*, see *Dirks*, 463 U.S. at 654–55, that otherwise could be read to suggest that disclosure duties are triggered only from the existence of a fiduciary relationship. See *O’Hagan*, 117 S. Ct. at 2212 (emphasizing that the Court in *Chiarella* did not hold that the insider/shareholder relationship was the only relationship triggering disclosure duties). Even before *O’Hagan*’s clarification of the dicta in *Chiarella* and *Dirks*, supporters of the “fraud on investors” misappropriation theory argued that the theory could be reconciled with *Chiarella* and *Dirks*. See NASAA Brief, *supra* note 16, at 12 (noting that “*Chiarella* expressly leaves open the possibility of this alternative duty of disclosure to the marketplace” and that while dicta in *Dirks* “might arguably be read to foreclose this avenue . . . the Court’s holding . . . does not foreclose a viable alternative duty of disclosure when there has been a misappropriation”).

³⁸² *Dirks*, 463 U.S. at 665. A few years later, the Supreme Court referenced this statement in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985) when it quoted *Dirks* for the proposition that “a tippee may be liable if he otherwise ‘misappropriate[s] or illegally obtain[s] the information.’” *Id.* at 313 n.22 (quoting *Dirks*, 463 U.S. at 665).

under Section 10(b) and Rule 10b-5 to someone other than the source of the information—investors in the marketplace constitute the only logical alternative.

Restructuring the misappropriation theory to make fraud on investors central is also in keeping with the public policy justifications offered by the Court in both *Chiarella* and *Dirks*. As Professor Langevoort has observed, the opinions in these cases “were heavily influenced by the Court’s desire to recognize the ability of some market participants—especially investment analysts—to exploit informational advantages free of the chill of the rule, under the assumption that such exploitation is at the heart of market efficiency and therefore is of value to all investors.”³⁸³ Unlike recognition of the broad disclosure duty stemming from the parity of information theory, recognition of a narrow duty to disclose misappropriated information does nothing to reduce incentives to obtain information through research or other legal and legitimate means.³⁸⁴ Indeed, it simply reduces the incentive to misappropriate nonpublic information by eliminating a purpose for which it ordinarily can be used. And few would debate the wisdom of a rule with an effect of reducing the incidence of corporate theft.

Having reconciled the “fraud on investors” misappropriation theory with both *Chiarella* and *Dirks*, the final question to be analyzed is whether *O’Hagan’s* endorsement of the “fraud on the source” version forecloses any further consideration of an alternative version that focuses on a misappropriator’s “fraud on investors.” In other words, after *O’Hagan*, is a lower court free to recognize this broader approach to the issue of insider trading liability under Section 10(b) and Rule 10b-5? Several aspects of the *O’Hagan* decision indicate that the “fraud on investors” misappropriation theory could in fact stand as a viable alternative to the “fraud on the source” version that was endorsed by the majority.

First, although the Court in *O’Hagan* acknowledged the existence of a broader version of the misappropriation theory, the Court was careful to limit its analysis to the specific “fraud on the source” theory advanced by the Government. For example, in addressing the Eighth Circuit’s reversal of *O’Hagan’s* convictions under Section 10(b) and Rule 10b-5, the Court focused on the section of the Government’s indictment charging “that *O’Hagan defrauded his law firm and its client, Grand Met*, by using for his own trading purposes material, nonpublic information regarding Grand Met’s planned tender offer [of Pillsbury].”³⁸⁵ Later in the opinion, the Court stated explicitly that “[u]nder the misappropriation theory urged in this case, the disclosure obligation

³⁸³ Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 *FORDHAM L. REV.* S7, S14 (1993).

³⁸⁴ See *supra* note 371.

³⁸⁵ *O’Hagan*, 117 S. Ct. at 2205 (emphasis added).

runs to the source of the information, here, Dorsey & Whitney and Grand Met,³⁸⁶ and that “[d]eception through nondisclosure [to the source of the information] is central to the theory of liability for which the Government seeks recognition.”³⁸⁷ It was also “[t]he misappropriation theory advanced by the Government”³⁸⁸ that the *O’Hagan* Court reconciled with its previous dictate in *Santa Fe* that a finding of deception, rather than merely a breach of fiduciary duty, is essential for liability under Section 10(b) and Rule 10b-5.³⁸⁹ Particularly when taken together, these statements suggest that the Court intentionally sought to limit its statutory analysis to the Government’s “fraud on the source” theory.

The manner in which the Court acknowledged the existence of a broader “fraud on investors” misappropriation theory also supports the conclusion that this theory continues to be viable in the wake of *O’Hagan*. Indeed, the sum total of the Court’s analysis of the “fraud on investors” theory was contained in a footnote referencing Chief Justice Burger’s dissenting opinion in *Chiarella* and noting that “the disclosure obligation, as he envisioned it, ran to those with whom the misappropriator trades.”³⁹⁰ The Court then commented only that “[t]he Government does not propose that we adopt a misappropriation theory of that breadth.”³⁹¹ The Court’s silence as to the validity of Chief Justice Burger’s position suggests that, while it may have declined to adopt the “fraud on investors” theory on this occasion, it may well have sought to preserve the “fraud on investors” theory for future consideration.

O’Hagan’s characterization of the “fraud on investors” theory as one of “breadth” may nonetheless be read by some as an expression of concern on the part of the Court as to the wisdom of that theory. Yet, even if this oblique statement by the Court were intended to express concern about a broader theory,

³⁸⁶ *Id.* at 2208 n.6 (emphasis added).

³⁸⁷ *Id.* (emphasis added).

³⁸⁸ *Id.* at 2209 (emphasis added).

³⁸⁹ *See id.* (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977)). The Court subsequently noted in a footnote that “the textual requirement of deception precludes § 10(b) liability when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from, the principal.” *Id.* at 2111 n.9. Although this footnote has been read to implicitly reject a “fraud on investors” misappropriation theory, *see Leading Cases: Misappropriation Theory of Insider Trading*, 111 HARV. L. REV. 410, 415 (1997), the more likely intent of the footnote is to highlight once again that the misappropriation theory endorsed by the Court premised the textual requirement of deception on the fiduciary’s “feigning fidelity” to the source of the information. *See O’Hagan*, 117 S. Ct. at 2209. Clearly, with permission from the source, or where there has been full disclosure to the source, there would be no deception of the source to satisfy the textual requirements of Section 10(b) and Rule 10b-5. *See id.* at 2208–09.

³⁹⁰ *O’Hagan*, 117 S. Ct. at 2208 n.6.

³⁹¹ *Id.*

such concern would have been unfounded. Because the “fraud on investors” theory is predicated on proof that there has been an unlawful misappropriation, the theory’s “breadth” will come into play primarily in those cases where the misappropriator does not stand in a fiduciary relationship with the source of the information, or in those cases where a fiduciary informs the source of his trading intention but proceeds to trade without authorization or permission. Neither one of these situations implicate legitimate activities relating to securities trading.³⁹²

Viewed in this practical light, it is difficult to see why the *O'Hagan* majority would be opposed to recognizing Section 10(b) and Rule 10b-5 liability in those additional cases where securities are traded on the basis of misappropriated information but which fail to fit within the “deceit by a fiduciary” paradigm. To be sure, the Court’s policy justifications for its narrower “fraud on the source” version are equally germane to a broader misappropriation theory premised on a fraud on investors.³⁹³ Indeed, without citing him specifically, the majority makes the very same policy point that Chief Justice Burger advanced in *Chiarella*; namely, that “[a]n investor’s informational disadvantage vis-à-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.”³⁹⁴

³⁹² See *supra* notes 250–55 and accompanying text. Moreover, as noted above, whether or not “contemporaneous traders” are deemed to be deceived and defrauded by a misappropriator’s fraud on the source, Section 20A (added to the Exchange Act by Congress as part of ITSFEA) already accords such private plaintiffs an express right of action against persons who purchase or sell securities while in possession of material, nonpublic information in violation of Exchange Act provisions or rules promulgated thereunder. See *supra* notes 289–95 and accompanying text. A misappropriation theory that recognizes “fraud on investors” as the violation of Section 10(b) and Rule 10b-5 would therefore have only a negligible impact on the amount of private litigation that is instituted for insider trading.

Ironically, it is *O'Hagan*’s own “fraud on the source” version of the misappropriation theory that raises a concern about private litigation that would not be implicated under the alternative “fraud on investors” theory: because *O'Hagan*’s theory posits that the source of the information is the party deceived and defrauded within the meaning of Section 10(b) and Rule 10b-5, it opens the door to possible *implied* private actions against alleged misappropriators by sources of information who seek to recover damages and who can satisfy *Blue Chip Stamps*’s “purchaser or seller” requirement for standing. See *supra* notes 283–84 and accompanying text (discussing implied actions under Rule 10b-5 initiated by Litton Industries and Anheuser-Busch against fiduciaries whose securities transactions were based on misappropriated information). These types of actions by private plaintiffs raise difficult issues because, as noted above, compensating a source for a person’s intrusion on its exclusive right to information seems to be a goal that is far removed from the investor protection and market integrity based objectives underlying federal securities regulation. See *supra* notes 220–21 and accompanying text.

³⁹³ See *supra* notes 240–46 and accompanying text.

³⁹⁴ *O'Hagan*, 117 S. Ct. at 2210. Compare *id.*, with *Chiarella*, 445 U.S. at 240 (Burger,

Accordingly, because trading based on misappropriated information would have much the same inhibiting market impact regardless of whether O'Hagan, a computer hacker, a "mere" thief, or a brazen fiduciary is permitted to trade on misappropriated information,³⁹⁵ recognition of the broader "fraud on investors" theory would be even more "well tuned" to the policy objectives advocated by Congress and echoed by the *O'Hagan* majority.

In short, because securities trading based on misappropriated information falls within the textual proscriptions in Section 10(b) and Rule 10b-5,³⁹⁶ and because *O'Hagan* advocates an approach to statutory interpretation that considers the investor protection and market integrity policy objectives underlying the federal securities laws,³⁹⁷ indirect support for the "fraud on investors" misappropriation theory may even be drawn from *O'Hagan* itself.

V. CONCLUSION

Although the Supreme Court reached a correct result, *United States v. O'Hagan* may be criticized both for what it did and for what it did not do. By endorsing an unnecessarily restrictive and misleading "fraud on the source" misappropriation theory, the Court passed up the opportunity to adopt an alternative theory that, for a host of reasons, would have been far superior. But *O'Hagan* fortunately left room for the recognition of additional disclosure duties under Section 10(b) and Rule 10b-5. To obtain the benefits of a broader theory that is supported by both statutory text and congressional policy, the misappropriation theory of insider trading liability should be reframed to acknowledge that those investors who trade in the marketplace with a person using misappropriated information are not only injured but are also deceived and defrauded.

C.J., dissenting) (noting that, when a defendant trades on misappropriated information, the "informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means"), and *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting) ("An investor who purchases securities on the basis of misappropriated nonpublic information possesses just such an 'undue' trading advantage; his conduct quite clearly serves no useful function except his own enrichment at the expense of others.").

³⁹⁵ See *supra* Part III.B.3.a.

³⁹⁶ See *supra* Part IV.A.2.

³⁹⁷ See *supra* note 352 (citing statements by commentators that *O'Hagan* marks a significant departure from recent decisions limiting the scope of liability under Section 10(b) and is reminiscent of the Court's expansive interpretations in the 1960s and early 1970s).