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# UNITED STATES v. O'HAGAN: A RESULTS-ORIENTED APPROACH TO INSIDER TRADING CASES

## INTRODUCTION

The 1933 Securities Act and the 1934 Securities Exchange Act were created to “embrace a fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of caveat emptor.”<sup>1</sup> An animating purpose of the 1934 Act was “to insure honest securities markets and thereby promote investor confidence.”<sup>2</sup> Throughout the 1980's and 1990's, abuses in the securities markets have gained the attention of more than just the Securities and Exchange Commission (“SEC”). Various reports about these abuses, in particular insider trading scandals, have become commonplace in the media.<sup>3</sup> To combat the abuse of insider trading, the SEC has relied on §§ 10(b)<sup>4</sup> and 14(e)<sup>5</sup> and Rules 10b-5<sup>6</sup> and 14e-3<sup>7</sup> of the 1934 Act.

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1. *Central Bank v. First Interstate Bank*, 511 U.S. 164, 171 (1994) (citations omitted).

2. 15 U.S.C. § 78a (1997).

3. A search of the *Wall Street Journal* alone under the subject heading of “insider trading” revealed 781 stories dealing with insider trading violations.

4. 15 U.S.C. § 78j(b). Section 10(b) provides in relevant part that:

It shall be unlawful for any person . . . [t]o 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.*

5. 15 U.S.C. § 78n(e). Section 14(e) provides in relevant part that:

It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . . The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

*Id.* Section 14(e), unlike § 10(b), only deals with manipulative or deceptive practices in the tender offer setting. *Id.* A tender offer is defined as a public offer to buy a minimum number of shares of a corporation, usually at a premium over market price, in order to take control of a corporation. BLACK'S LAW DICTIONARY 621 (Pocket ed. 1996). Section 10(b) applies, however, regardless of whether a tender offer exists for the shares in which the insider-defendant trades. 15 U.S.C. § 78j(b).

6. 17 C.F.R. § 240.10b-5(c) (1996). Rule 10b-5 provides in relevant part that: “It shall be unlawful for any person . . . by the use of any . . . national securities exchange . . . [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.” *Id.*

7. 17 C.F.R. § 240.14e-3(a)(1)-(3). Rule 14e-3 provides in relevant part that:

[I]t shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason

Rule 10b-5 liability is based on a duty to disclose which arises from a specific relationship between the parties and not merely from one's ability to obtain market information.<sup>8</sup> The "classical theory" of this liability is limited to situations in which the insider has a duty to disclose nonpublic material information to his corporation in whose shares he trades.<sup>9</sup> Since *Chiarella v. United States*,<sup>10</sup> the SEC has urged the Supreme Court to expand 10b-5 liability by accepting the "misappropriation theory."<sup>11</sup> This theory extends liability based on a breach of a duty to disclose that is owed to the source of the trader's information.<sup>12</sup> Under this theory, the trader does not have to owe a duty to the corporation in whose shares he trades or to the party with whom he trades.<sup>13</sup>

Prior to *O'Hagan*, the circuit courts had split over whether the misappropriation theory was a valid extension of Rule 10b-5 liability. The Seventh, Second, and Ninth Circuits had adopted the theory as a valid use of Rule 10b-5.<sup>14</sup> The Eighth and Fourth circuits, however,

to know is nonpublic . . . to purchase or sell or cause to be purchased or sold any of such securities.

*Id.*

8. *Chiarella v. United States*, 445 U.S. 222, 233 (1980).

9. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2207 (1997). The *O'Hagan* Court said an insider violates Rule 10b-5 when the insider trades in the securities of his corporation on the basis of nonpublic, material information. *Id.* The Court found that such trading is "deceptive" under § 10(b) because there is a relationship of trust and confidence between the corporation's shareholders and corporate insiders who have obtained nonpublic information because of their position with the corporation. *Id.* The Court then stated that:

The relationship, we recognized, "gives rise to a duty to disclose [or to abstain from trading] because of the necessity of preventing a corporate insider from tak[ing] unfair advantage of uninformed stockholders." The classical theory applies not only to officers, directors and other permanent insiders of a corporation, but also to attorneys, accountants, consultants, and others who temporarily become fiduciaries of a corporation.

*Id.* (citations omitted).

10. 445 U.S. 222. This was the first case in which the Court was presented with the misappropriation theory, but the Court declined to rule on the validity of the theory because it had not been submitted to the jury at the trial level. *Id.* at 235-36.

11. See *O'Hagan*, 117 S. Ct. at 2213-14 (sustaining a finding of criminal liability under the misappropriation theory); *Carpenter v. United States*, 484 U.S. 19, 28 (1987) (affirming a 10b-5 violation for conspiracy to trade on confidential information). See *infra* notes 85-88 and accompanying text for a discussion of this case.

12. *O'Hagan*, 117 S. Ct. at 2207 (explaining the implications of the misappropriation theory).

13. *Id.*

14. See *S.E.C. v. Cherif*, 933 F.2d 403, 418 (7th Cir. 1991) (finding a "common sense" notion of fraud in the misappropriation theory and that this notion is consistent with § 10(b) fraud); *S.E.C. v. Clark*, 915 F.2d 439, 448 (9th Cir. 1990) (accepting the misappropriation theory because it complied with the fraud requirement of § 10(b)); *United States v. Newman*, 664 F.2d 12, 16 (2d Cir. 1981) (basing liability on the breach of any duty to disclose by the trader regardless of whether the trader owes any duty to the corporation in whose shares he trades or to the person with whom he trades).

rejected the theory on the basis that it is inconsistent with the language of § 10(b).<sup>15</sup> In *United States v. O'Hagan*,<sup>16</sup> the Supreme Court resolved this dispute in favor of the misappropriation theory.<sup>17</sup>

The *O'Hagan* Court also dealt with § 14(e) and Rule 14e-3 of the 1934 Securities Exchange Act, which outline liability in the tender offer context. Rule 14e-3 was promulgated by the SEC, pursuant to § 14(e), as a means of prohibiting the use of nonpublic material information regarding a tender offer.<sup>18</sup> This rule makes it fraudulent for a person to sell or purchase securities in the target-company of a tender offer when the person has nonpublic information of the tender offer regardless of whether the person owes a fiduciary or similar duty to anyone else.<sup>19</sup> In a 1985 case, the Supreme Court ruled that § 14(e) allows the SEC to prescribe broad rules, but limited this power by holding that these rules must not change the meaning of "fraud."<sup>20</sup> Three circuits have upheld Rule 14e-3 as a valid use of the SEC's § 14(e) rulemaking power.<sup>21</sup> The Eighth Circuit became the first circuit to hold Rule 14e-3 invalid, citing the rule's definition of fraud as its fatal flaw.<sup>22</sup> The Supreme Court's *O'Hagan* decision has resolved this dispute in favor of the SEC, but it has limited this part of the ruling to the particular facts of this case.<sup>23</sup>

This Note critically examines the Court's opinion in *United States v. O'Hagan*, concluding that the Court adopted a results-oriented approach to reach a decision that it felt was "fair" and consistent with the general policies underlying §§ 10(b) and 14(e) of the 1934 Act. Part I of the Note traces the history and development of insider trading case law leading up to the *O'Hagan* decision.<sup>24</sup> Part II of the Note

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15. See *United States v. O'Hagan*, 92 F.3d 612, 622 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997) (rejecting the theory because it failed to require a showing of a deception and it failed to require that the deception be in connection with a securities transaction); *United States v. Bryan*, 58 F.3d 933, 952-53 (4th Cir. 1995) (rejecting the misappropriation theory as reaching beyond the meaning of the language of § 10(b)).

16. 117 S. Ct. 2199.

17. *Id.* at 2213-14.

18. 17 CFR § 240.14e-3 (1996).

19. *Id.*

20. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 11 (1985) (allowing the SEC to regulate nondeceptive acts as a reasonable means in preventing manipulative acts; however, the manipulative act had to involve a misrepresentation or nondisclosure). See *infra* notes 116-19 and accompanying text for a discussion of this case.

21. See *S.E.C. v. Maio*, 51 F.3d 623, 635 (7th Cir. 1995) (holding Rule 14e-3 valid as a use of the rulemaking power of § 14(e)); *S.E.C. v. Peters*, 978 F.2d 1162, 1167 (10th Cir. 1992) (same); *United States v. Chestman*, 947 F.2d 551, 558 (2d Cir. 1991) (holding that § 14(e) allowed the SEC to make a rule that extended beyond the common law meaning of "fraud").

22. *United States v. O'Hagan*, 92 F.3d 612, 624 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

23. *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

24. See *infra* Part I.

presents the Court's decision and reasoning.<sup>25</sup> Part III critically analyzes the Court's decision to adopt the misappropriation theory and to hold Rule 14e-3 valid in the present factual context.<sup>26</sup> Specifically, this part argues that the Court's decision to validate the misappropriation theory is based more on general policy concerns than precedent or statutory language. This part also argues that the Court's acceptance of Rule 14e-3 lacks much reasoned support and leaves the door open as to how far Rule 14e-3 liability will reach in the future. Part IV contends that the effectiveness of the misappropriation theory will be limited and that the Court will eventually extend Rule 10b-5 liability beyond the misappropriation theory.<sup>27</sup> This part also asserts that the future impact and extension of Rule 14e-3 is uncertain. Lastly, this part suggests that a catch-all rule such as Rule 14e-3, if valid, may be a more effective tool to combat insider trading than the misappropriation theory.

## I. HISTORY AND DEVELOPMENT OF INSIDER TRADING CASELAW

### A. *State Common Law Dealing with Insider Trading*

The common law that existed prior to the 1934 Act did not provide much of a deterrent to insider trading. Although the laws dealing with insider trading varied from state-to-state, most state courts held that insiders owed a duty to the corporation.<sup>28</sup> This duty, however, did not extend to individual shareholders.<sup>29</sup> Thus, in most cases shareholders did not have much recourse when they became victims of insider trading. If an insider bought stock via the stock exchange, the insider did not owe a duty to disclose material information to the sellers.<sup>30</sup> Fur-

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25. See *infra* Part II.

26. See *infra* Part III.

27. See *infra* Part IV.

28. Michael J. Voves, Note, *United States v. O'Hagan: Improperly Incorporating Common Law Fiduciary Obligations into § 14(e) of the Securities Exchange Act*, 81 MINN. L. REV. 1015, 1021 (1997).

29. *Id.* at 1021 n.30 (citing secondary sources that discuss the unwillingness of courts to find a fiduciary duty between directors/officers and individual stockholders).

30. See *Goodwin v. Agassiz*, 186 N.E. 659, 660-63 (Mass. 1933). The Court found the burden on the insider of seeking out the seller to disclose all information to be too onerous.

An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares . . . . Fiduciary obligations of directors ought not to be made so onerous that men of experience and ability will be deterred from accepting such office. Law in its sanctions is not coextensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill and shrewdness.

thermore, insiders selling stock to another party did not owe a duty to disclose nonpublic material information to the other party.<sup>31</sup>

Some jurisdictions, however, did find exceptions to the general rules.<sup>32</sup> In *Goodwin v. Agassiz*,<sup>33</sup> the Massachusetts court found that a director did not owe a general duty to an individual shareholder, but it noted that an insider might be liable if the insider actively sought out and persuaded a stockholder to sell shares to the insider.<sup>34</sup> In *Hotchkiss v. Fischer*,<sup>35</sup> the Kansas Supreme Court required full disclosure by a director or officer when dealing face-to-face with a shareholder.<sup>36</sup> The final exception to the rule was the "special facts" exception developed by the Supreme Court in *Strong v. Repide*.<sup>37</sup> In *Strong*, the Court said that even when a director does not have a general duty to disclose to shareholders, "there are cases where, by reason of the special facts, such duty exists."<sup>38</sup>

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*Id.*

31. See *Voves*, *supra* note 28, at 1021.

32. *Id.*

33. 186 N.E. 659 (Mass. 1933).

34. *Id.* at 660-61. This court held that a director might be liable for fraud for personally seeking out a shareholder from whom to buy shares. *Id.* "[W]here a director personally seeks a stockholder for the purpose of buying his shares without making disclosure of material facts within his peculiar knowledge and not within reach of the stockholder, the transaction will be closely scrutinized and relief may be granted in appropriate instances." See *George v. Ford*, 36 App. D.C. 315, 329 (D.C. Cir. 1911) (holding insider liable for persuading stockholder to sell his shares in the corporation).

35. 16 P.2d 531 (Kan. 1932).

36. *Id.* at 534. The court, citing § 165 of Restatement of the Law of Trusts, stated that a director had a duty to "communicate . . . all material facts in connection with the transaction which the [director] knows or should know." *Id.*

37. 213 U.S. 419 (1909).

38. *Id.* at 431. In this case, the defendant owned three quarters of a sugar company and was also a director of the company. *Id.* at 421. The company had no funds and was paying no dividends. *Id.* at 423. The defendant was in charge of negotiating the sale of company property to the U.S. government. *Id.* at 424. The plaintiff decided to put her shares up for sale since the company was not paying a dividend and the negotiations with the government were dragging on because the defendant was holding out for a higher price. *Id.* The defendant secretly purchased the plaintiff's shares and then agreed to a deal with the government. *Id.* at 424-25. After the deal with the government, the price of the company's shares increased ten-fold. *Id.* at 426. Based on these facts, the Court found a duty on the part of the defendant, as a director, to disclose certain facts before purchasing shares in the company. *Id.* at 434; see *Chiarella v. United States*, 445 U.S. 222, 247 (1980) (Blackmun, J., dissenting). Justice Blackmun criticized the majority opinion for not stressing the importance of "possession of 'special facts' as a key element in the duty to disclose." *Id.* Blackmun then elaborated on the meaning and application of "special facts" to situations involving fiduciary relations, saying the doctrine should be applied when "one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair." *Id.*

More often than not, these exceptions did not apply. The inconsistent and lenient nature of state common law did not provide much protection against insider trading.

*B. Passage of the Securities Exchange Act and the Development of § 10(b) and Rule 10b-5 Liability*

Congress passed the Securities Exchange Act of 1934 in response to abuses in the securities industry, caused in part by ineffective state laws.<sup>39</sup> This law expressed Congress' intent to promote full disclosure in securities transactions.<sup>40</sup> The subsequent development of Rule 10b-5 under the 1934 Act has provided a more effective deterrent against insider trading than the previous state common law.

*1. Caselaw Tracing the Development of Rule 10b-5*

Originally, courts limited the application of Rule 10b-5 to situations involving nondisclosure where a common law fiduciary duty between the parties to the transaction required disclosure.<sup>41</sup> The effect of this early interpretation was to limit liability to traditional insiders.<sup>42</sup> During the 1950's and 1960's, however, the courts gradually expanded liability under Rule 10b-5. The first sign of the impending expansion of liability under 10b-5 was made apparent by the Eastern District of Pennsylvania in *Kardon v. National Gypsum Co.*<sup>43</sup> The court found an implied right to private civil actions under § 10(b), despite the lack of an express statutory authorization for private remedies under § 10(b).<sup>44</sup> Five years later, in *Speed v. Transamerica, Corp.*,<sup>45</sup> the court held that an insider owed a fiduciary duty to disclose informa-

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39. 15 U.S.C. § 78(a) (1997); see Shawn J. Lindquist, Note, *United States v. O'Hagan: The Eighth Circuit Throws the Second Strike to the Misappropriation Theory of Rule 10b-5 Liability*, 1997 BYU L. REV. 197, 198 (1997). "[I]n an attempt to curtail excessive abuses in the securities industry, the Seventy-third Congress enacted . . . the Securities Exchange Act of 1934." *Id.*

40. *Central Bank v. First Interstate Bank*, 511 U.S. 164, 171 (1994).

41. See *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir. 1952) (noting that Rule 10b-5 was only meant to protect defrauded purchasers or sellers, and that it was not intended to protect shareholders in general).

42. Timothy Sullivan, Note, *We're Still Against Fraud, Aren't We?* *United States v. O'Hagan: Trimming the Oak in the Wrong Season*, 71 ST. JOHN'S L. REV. 197, 204 (1997).

43. 69 F. Supp. 512, 514 (E.D. Pa. 1946) ("[T]he mere omission of an express provision for civil liability is not sufficient to negative what the general law implies."). See also *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13-14 (1971) (finding an implied private right of action under Rule 10b-5).

44. *Kardon*, 69 F. Supp. at 514; see also *supra* notes 4 & 6 for the text of § 10(b) and Rule 10b-5.

45. 99 F. Supp. 808 (D. Del. 1951).

tion to minority shareholders before trading with these shareholders.<sup>46</sup> The *Speed* ruling represented a departure from previous decisions limiting the parties to whom an insider owed a fiduciary duty. The SEC and various courts also found that a fiduciary duty existed when the insider traded via securities exchanges and sold stock to non-shareholders.<sup>47</sup>

The most significant and liberal developments of Rule 10b-5 liability occurred in *Cady, Roberts & Co.*<sup>48</sup> and *S.E.C. v. Texas Gulf Sulphur*.<sup>49</sup> In *Cady, Roberts & Co.*, an administrative hearing, the SEC held that an insider must either abstain from trading securities of a corporation when the trader has nonpublic material information, or disclose the nonpublic information before making the trade.<sup>50</sup> The SEC also found that people other than traditional corporate insiders could violate Rule 10b-5, holding that a duty to disclose applies to any person who has a "relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose."<sup>51</sup> Thus, this reading of the 10b-5 language transcended the traditional insider relationship and broadened liability to cover any relationship in which inside information is used. This theory of 10b-5 liability became known as the "equality of access" doctrine which holds that no one market participant should be able to use nonpublic information for his personal gain.<sup>52</sup>

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46. *Id.* at 829 (finding that this duty was meant to prevent insiders from taking unfair advantage of minority stockholders); see also *McClure v. Borne Chemical Co.*, 292 F.2d 824, 834 (3d Cir. 1961) (stating that § 10(b) created new liabilities not found in the common law).

47. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). The SEC found the defendant liable for violating Rule 10b-5 even though the trades occurred on a securities exchange. *Id.* at 914. The Commission also found that the defendant owed a duty when selling stock to non-shareholders. *Id.* at 913. The SEC cited *Gratz v. Claughton*, 187 F.2d 46, 49 (2d Cir.) (1951), for the proposition that a director owed a duty to the person to whom he sold. *Id.* at 914 n.23.

48. *Cady, Roberts & Co.*, 40 S.E.C. 907.

49. *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc).

50. *Cady, Roberts & Co.*, 40 S.E.C. at 911-12. This has become known as the "disclose or abstain" rule.

51. *Id.* at 911-12. Relying on the "any person" language found in Rule 10b-5, the SEC extended liability to any person who had access to nonpublic material information. *Id.* This spread liability to people other than traditional insiders such as directors, officers and controlling shareholders of a corporation. *Id.* The SEC said that these traditional insiders "do not exhaust the classes of persons upon whom there is such an obligation." *Id.*; see also *Dirks v. S.E.C.*, 463 U.S. 646, 655 n.14 (1983) (finding lawyers, accountants, underwriters and consultants to be liable under Rule 10b-5 even though they are not insiders in the traditional sense). See *infra* notes 89-92 and accompanying text for a discussion of this case.

52. See Lindquist, *supra* note 39, at 233 n.32.



Building on *Cady, Roberts & Co.*, the Second Circuit, in *Texas Gulf Sulfur*, adopted the "equality of access" doctrine,<sup>53</sup> with some caveats, and held that Rule 10b-5 prohibited almost all trading on inside information.<sup>54</sup> In this case, a Texas Gulf Sulfur geologist was involved in the discovery of a large mineral deposit for the company.<sup>55</sup> Subsequent to this find but prior to its public announcement, the geologist and a number of tippees bought shares in the company.<sup>56</sup> The court found the defendant liable under Rule 10b-5, stating that "anyone in possession of material inside information must either disclose it to the investing public, or . . . abstain from trading."<sup>57</sup> At the time, this ruling defined the outer reaches of Rule 10b-5 liability. Despite a subsequent Supreme Court case that seemed to give a broad reading to Rule 10b-5,<sup>58</sup> the scope of the rule's liability began to contract in the 1970's as the Court handed down a number of decisions concerning § 10(b) liability.

C. *The Contraction of Rule 10b-5 Liability and Chiarella v. United States*

In the mid to late 1970's, the Supreme Court narrowed the scope and liability of Rule 10b-5 in a number of ways, beginning with *Blue Chip Stamps v. Manor Drug Stores*.<sup>59</sup> In *Blue Chip Stamps*, the Court held that standing to bring suit in civil actions was limited to the purchaser or seller of securities. The Court stated that it based its decision on the language of § 10(b) and Rule 10b-5.<sup>60</sup> In *Ernst & Ernst v. Hochfelder*,<sup>61</sup> the Court held that 10b-5 liability required an intent to

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53. See *Cady, Roberts & Co.*, 40 S.E.C. at 912 (finding that the use of nonpublic information for other than a corporate purpose when dealing with a person who does not have access to the same information violates the equality of access doctrine). See also Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 354 (1979) (discussing the equality of access theory and its significance); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading after United States v. O'Hagan*, 84 VA. L. REV. 153, 163 n.39 (1998) (discussing the equality of access theory and its development by the *In re Cady, Roberts & Co.* and *Texas Gulf Sulphur* rulings).

54. *Texas Gulf Sulfur Co.*, 401 F.2d at 848. The court stated: "Whether predicated on traditional fiduciary concepts . . . , or on the 'special facts' doctrine . . . , the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . ." *Id.*

55. *Id.* at 843-47.

56. *Id.* at 847.

57. *Id.* at 848 (citing *Cady, Roberts & Co.*, 40 S.E.C. 907).

58. See *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-154 (1972) (citing Rule 10b-5 and *Texas Gulf Sulphur* in finding defendants liable for withholding information that a reasonable investor might consider important to an investment decision).

59. 421 U.S. 723 (1975).

60. *Id.* at 754-55.

61. 425 U.S. 185 (1983).

deceive, manipulate, or defraud.<sup>62</sup> The Court once again relied on the language of § 10(b) and rejected the SEC's argument that the Court should look only to the effect on investors.<sup>63</sup> In yet another civil case, *Santa Fe Industries v. Green*,<sup>64</sup> the Court emphasized the importance of looking to the language of § 10(b) and held that the section's language required that there be some sort of deception or manipulation to bring a Rule 10b-5 claim.<sup>65</sup>

The Court did not, however, address the substance of § 10(b) and Rule 10b-5 until *Chiarella v. United States*.<sup>66</sup> Prior to *Chiarella*, the Supreme Court had not clearly explained what constituted an insider trading violation under § 10(b) of the 1934 Act.<sup>67</sup> Thus, *Chiarella's* importance arose from the fact that it was the Court's first attempt to clearly define a § 10(b) violation, and as such, it established the framework for analyzing subsequent insider trading cases.

In *Chiarella*,<sup>68</sup> the defendant was an employee of a printing company that was printing documents containing information about possible takeovers of various companies.<sup>69</sup> The employee had access to these documents and was able to determine the targets of the tender offers.<sup>70</sup> The employee subsequently bought shares in the target companies and sold the stocks for a \$30,000 profit after the announcement of the tender offers.<sup>71</sup>

The Court agreed with the *Cady, Roberts & Co.* decision, holding that nondisclosure was within the reach of § 10(b) fraud.<sup>72</sup> The Court, however, limited the circumstances from which the duty to disclose arises, holding that a person with nonpublic material information has

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62. *Id.* at 193. The Court found that negligent conduct alone was not enough for Rule 10b-5 liability, requiring a showing of scienter to impose liability. *Id.*

63. *Id.* at 197-99.

64. 430 U.S. 462 (1977).

65. *Id.* at 473-77. The Court stated: "The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." *Id.* at 473. The Court found that there was no omission or misrepresentation in this case and that therefore, there could be no manipulation or deception as required by Rule 10b-5. *Id.* at 474. Finally, the Court noted that this case involved nothing more than a claim of corporate mismanagement and that § 10(b) was not created to regulate this type of behavior. *Id.* Corporate mismanagement, like all other claims not involving deception or manipulation, was to be dealt with by state law. *Id.* at 476-77.

66. 445 U.S. 222 (1980). See *supra* notes 8-13 and accompanying text for a discussion of the Court's role in the development of the misappropriation theory.

67. See *Chiarella*, 445 U.S. at 226-29 (discussing the development of insider trading law by lower courts and administrative agencies rather than by the Supreme Court).

68. 455 U.S. 222.

69. *Chiarella*, 445 U.S. at 224.

70. *Id.*

71. *Id.*

72. *Id.* at 230. See *supra* notes 48-52 and accompanying text discussing *Cady, Roberts & Co.*

a duty to abstain from trading or disclose the information only if there is a duty to disclose arising from a fiduciary relationship of trust and confidence between the parties to a transaction.<sup>73</sup> The Court also stated that the mere possession of nonpublic material information does not automatically give rise to a duty to disclose<sup>74</sup> because not every instance of financial unfairness constitutes fraud under § 10(b).<sup>75</sup> Thus, the Court rejected the “equality of access” theory of *Cady, Roberts & Co.* and *Texas Gulf Sulfur*.<sup>76</sup> The Court did find, however, that a breach of a duty to disclose arising from a fiduciary or similar relationship did constitute a § 10(b) fraud.<sup>77</sup>

The importance of *Chiarella* goes beyond its strict holding. The Court was also presented with the question of the misappropriation theory and its validity but chose not to address it in this case because the theory had not been presented to the jury at the trial level.<sup>78</sup> Four justices, including Chief Justice Burger expressed varying degrees of

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73. *Chiarella*, 445 U.S. at 228-33. The Court stressed that the duty to disclose arose only from a pre-existing fiduciary relationship to disclose. *Id.* The Court stated: “[T]he duty to disclose 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 them.’” *Id.* at 228. The Court also emphasized, for the first time, that this duty to disclose was based on the common law, and that if there was no duty to disclose then there would be no liability. *Id.* at 229. Finally, the Court said that the relationship of trust and confidence that creates the duty to disclose must be “between parties to a transaction.” *Id.* at 230. The Court refused to recognize a general duty between all market participants absent Congressional intent. *Id.* at 233.

74. *Id.* at 235.

75. *Id.* at 232. The Court also reaffirmed the “classical theory” of insider trading in which the defendant is a typical insider such as a director, officer or controlling shareholder who has access to nonpublic material information. *Id.* at 227. The defendant in this type of case has a fiduciary duty to the shareholders of his company. *Id.* at 228. Undisclosed trading in the shares of his company based on nonpublic information is a violation under the classical theory. *Id.* at 227-29. The Court also followed precedent by holding that an insider has a fiduciary duty to people buying into the company and holding tippees liable when they know they are using confidential information. *Id.* at 227-30.

76. *Id.* at 233. The Court stated that:

We cannot affirm petitioner’s conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent. As we have seen, no such evidence emerges from the language or legislative history of § 10(b). Moreover, neither Congress nor the Commission ever has adopted a parity-of-information rule.

*Id.*

77. *Id.* at 232-33. The Court determined in this case, however, that the defendant did not owe a duty to disclose to the sellers of the stock. *Id.* The Court stated: “No duty could arise from petitioner’s relationship with the sellers of the target company’s securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence.” *Id.* at 232.

78. *Id.* at 223, 236.

support for the theory.<sup>79</sup> As described by Chief Justice Burger, the theory would find a duty to disclose on the part of a person who has nonpublic material information because the person has obtained an informational advantage, not by superior experience or foresight, but through some unlawful means.<sup>80</sup> The Chief Justice, in his dissent, found that the defendant had unlawfully misappropriated nonpublic information and therefore had a duty to disclose this information before trading on it.<sup>81</sup> Thus, the nondisclosure in this case would constitute a fraud in connection with a securities trade.<sup>82</sup> Although this version of the theory was not adopted in this case, the Court specifically declined to address the issue, reserving it for another time.<sup>83</sup> From this point forward, the misappropriation theory would be presented in a number of cases, and ultimately adopted by several courts of appeal.<sup>84</sup>

The Court was given an additional opportunity to rule on the validity of the misappropriation theory in *Carpenter v. United States*.<sup>85</sup> In *Carpenter*, the defendant had been convicted under the misappropriation theory for violating Rule 10b-5.<sup>86</sup> The Court affirmed the convictions because it split evenly (4 to 4) on the validity of the misappropriation theory.<sup>87</sup> Neither arguments for nor against the theory were presented in the opinion.<sup>88</sup>

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79. *Chiarella*, 445 U.S. at 236, 238-51. Chief Justice Burger, in dissent, adopted the theory as a valid extension of Rule 10b-5. *Id.* at 240-42 (Burger, C.J., dissenting). Justice Brennan also expressed support for the misappropriation theory as defined by the Chief Justice. *Id.* at 239 (Brennan, J., concurring). Justices Blackmun and Marshall also accepted the misappropriation theory as defined by Chief Justice Burger. *Id.* at 245-51 (Blackmun, J., dissenting). However, they went beyond this theory and accepted the "equality of access" doctrine. *Id.* Justice Stevens found merit in arguments both for and against the theory and thought it was wise to leave the question of the misappropriation theory's validity to another time. *Id.* at 238 (Stevens, J., concurring).

80. *Id.* at 240. In dissent, Chief Justice Burger said:

I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading. The language of § 10(b) and of Rule 10b-5 plainly supports such a reading.

*Id.* (Burger, C.J., dissenting).

81. *Id.* at 245 (Burger, C.J., dissenting).

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

83. *Id.* at 236.

84. See *S.E.C. v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *S.E.C. v. Clark* 915 F.2d 439 (9th Cir. 1990); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981).

85. 484 U.S. 19 (1987).

86. *Id.* at 24.

87. *Id.*

88. *Id.*

One other important Supreme Court case that reaffirmed the *Chiarella* decision was *Dirks v. S.E.C.*<sup>89</sup> In *Dirks*, the Court stated that a duty to disclose cannot arise unless the person who traded on nonpublic information had a relationship of trust and confidence with the sellers of the securities.<sup>90</sup> The Court further stated that "not all breaches of a fiduciary duty in connection with a securities transaction" fall within the scope of § 10(b).<sup>91</sup> The Court reemphasized the fact that Rule 10b-5 requires that a manipulation or deception must occur to violate the rule.<sup>92</sup>

#### D. *Post-Chiarella Dissatisfaction in the Lower Courts*

##### 1. *Lower Courts Adopting the Misappropriation Theory*

A number of lower courts seemed dissatisfied with the contracted scope of Rule 10b-5 liability after *Chiarella*.<sup>93</sup> Of these courts, three circuits adopted the misappropriation theory as a valid extension of Rule 10b-5 liability.<sup>94</sup> In *United States v. Newman*,<sup>95</sup> the Second Circuit held that any person who uses nonpublic material information in breach of a fiduciary or similar duty to any person, in connection with a securities transaction, is liable under Rule 10b-5.<sup>96</sup> The Ninth Cir-

89. 463 U.S. 646 (1983). Unlike *Chiarella*, *Dirks* did not deal specifically with the misappropriation theory. *Id.* at 649. In this case, the defendant was a tippee who had received nonpublic information. *Id.* The Court said that a tippee's duty to disclose or abstain comes from the information source's breach of duty to the company's shareholders. *Id.* at 655. Thus, the tippee's liability derives from the source's breach of duty. *Id.* The Court also stated that it must be proven that the tippee knew or should have known of the breach. *Id.* at 660. The Court also found that accountants, lawyers and consultants may enter into a special fiduciary relationship with the company when they are given access to nonpublic material information solely for corporate purposes. *Id.* at 655 n.14.

90. *Id.* at 654 (citing *Chiarella v. United States*, 445 U.S. 222, 232 (1980)).

91. *Id.* (citing *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1997)). The Court said that *Chiarella* stood for the proposition that "only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information." *Id.* at 657.

92. *Id.* at 654 (citing *Santa Fe Indus.*, 430 U.S. at 473).

93. See *S.E.C. v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *S.E.C. v. Clark* 915 F.2d 439 (9th Cir. 1990); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981); see Linquist, *supra* note 39, at 206 (discussing the dissatisfaction of some lower courts with *Chiarella*).

94. *Cherif*, 933 F.2d 403; *Clark*, 915 F.2d 439; *Newman*, 664 F.2d 12. The Third Circuit may have also implicitly adopted the misappropriation theory. See *Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3d Cir. 1985).

95. 664 F.2d 12 (2d Cir. 1981).

96. *Id.* at 17-18. The court found that the defendants' use of confidential information in a securities trade constituted fraud. *Id.* at 17. The court said the sullyng of the reputation of the defendants' employers was the equivalent of the defendants stealing the employers' money. *Id.* at 17. The court also found that the fraud in this case was connected to a securities trade because the defendants' sole purpose in misappropriating confidential information was for use in purchasing shares of takeover targets. *Id.* at 18.

cuit, in *S.E.C. v. Clark*,<sup>97</sup> validated the theory, stating that it was consistent with the meaning of fraud under § 10(b).<sup>98</sup> In *S.E.C. v. Cherif*,<sup>99</sup> the Seventh Circuit adopted the misappropriation theory, finding a “common sense” notion of fraud in the theory that comports with the meaning of fraud under § 10(b).<sup>100</sup> The adoption of the misappropriation theory by these courts allowed liability to be placed on the defendant, regardless of whether the defendant owed a duty to the shareholders of the company.<sup>101</sup> This theory extended the scope of Rule 10b-5 liability as defined in *Chiarella*.

## 2. Two Circuit Courts Reject the Misappropriation Theory

The first court of appeals to reject the misappropriation theory was the Fourth Circuit in *United States v. Bryan*,<sup>102</sup> which found that the theory was inconsistent with the language of § 10(b), Rule 10b-5 and previous Supreme Court rulings.<sup>103</sup> The court said that it was following the *Chiarella* Court’s admonition of not going beyond the meaning of the words found in Rule 10b-5.<sup>104</sup>

The Eighth Circuit, in *United States v. O’Hagan*,<sup>105</sup> followed the lead of the Fourth Circuit in rejecting the misappropriation theory, declaring that a literal reading of the statute, as required by *Chiarella*, was dispositive of this case.<sup>106</sup> It found the theory lacking in two respects: (1) the theory did not require deception as required by § 10(b); and (2) the theory did not require that the deception be in connection with a securities transaction.<sup>107</sup> The court believed that the theory made the “in connection with” requirement of Rule 10b-5 meaningless and allowed for a breach of a fiduciary duty without a showing of deception.<sup>108</sup> Thus, the court rejected this theory for its

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97. 915 F.2d 439.

98. *Id.* at 449.

99. 933 F.2d 403.

100. *Id.* at 410.

101. *See* Linquist, *supra* note 39, at 206-07.

102. 58 F.3d 933 (4th Cir. 1995).

103. *Id.* at 943-44. The court rejected the theory because, in the court’s opinion, the theory neither required deception as defined in § 10(b), nor required that the parties wronged be purchasers or sellers of securities. *Id.* at 944.

104. *Id.* at 945.

105. 92 F.3d 612 (1996), *rev’d*, 117 S. Ct. 2199 (1997).

106. *Id.* at 617-19.

107. *Id.* at 618.

108. *Id.* The court said the basis for its rejection of the misappropriation theory was “in part, because it permits the imposition of Section 10b liability based upon the mere breach of a fiduciary duty without a particularized showing of misrepresentation or nondisclosure.” *Id.* The court also said the theory “permits liability for a breach of duty owed to individuals who are uncon-

failure to satisfy the requirements explicitly stated in the statute.<sup>109</sup> The circuit split that emerged over the misappropriation theory after *Chiarella* has been resolved by the Supreme Court in *United States v. O'Hagan*.<sup>110</sup>

*E. The Creation of § 14(e) and Rule 14e-3 to Combat Insider Trading in the Tender Offer Setting*

*United States v. O'Hagan* also discussed § 14(e) of the 1934 Securities Exchange Act and its attempts to combat insider trading. This section was patterned after § 10(b) of the Act.<sup>111</sup> Section 14(e), which deals specifically with tender offers, also enables the SEC to make rules enforcing it.<sup>112</sup> Pursuant to this power, the SEC promulgated Rule 14e-3 in 1980,<sup>113</sup> which requires traders to abstain or disclose whenever they have nonpublic material information concerning a tender offer target.<sup>114</sup> Unlike Rule 10b-5, this rule does not base the disclosure requirement on the presence of a fiduciary or similar duty.<sup>115</sup> The Supreme Court had not ruled on the validity of Rule

nected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with' statutory language." *Id.*

109. *Id.* at 622 ("[T]he misappropriation theory is not a valid basis upon which to impose criminal liability under § 10(b).").

110. 117 S. Ct. 2199 (1997).

111. 15 U.S.C. § 78j(b) (1997). Section 14(e) uses substantially the same language as § 10(b). *Id.* Section 10(b) prohibits the use "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." *Id.* Section 14(e) prohibits "any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer." *Id.* See also Voves, *supra* note 28, at 1028-29 for a discussion of the history of § 14(e) and Rule 14e-3. A tender offer is defined as a public offer to buy a minimum number of shares of a corporation, usually at a premium over market price, in order to take control of a corporation. BLACK'S LAW DICTIONARY 621 (Pocket ed. 1996).

112. See 15 U.S.C. § 78n(e) (stating that the SEC can "define, and prescribe means reasonably designed to prevent, such acts and practices that are fraudulent, deceptive, or manipulative").

113. 17 C.F.R. § 240.14e-3 (1996).

114. *Id.*

115. Compare § 240.14e-3 (1996) (banning the use of nonpublic information in the tender offer setting and imposing liability without proof of fraud), with § 240.10b-5 (requiring proof of fraud or deception). Rule 14e-3 states:

[I]t shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of Section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from the issuer of the securities or an officer, director or employee of the issuer, to purchase or sell such securities unless such information and its source are publicly disclosed prior to any purchase or sale.

Section 240.14e-3. There is no mention of any need for a preexisting fiduciary duty. *Id.* Rule 10b-5, on the other hand, states: "It shall be unlawful for any person, directly or indirectly, . . .

14e-3 before *United States v. O'Hagan*, but it did outline the general scope of § 14(e) in *Schreiber v. Burlington Northern, Inc.*<sup>116</sup>

In *Schreiber*, the Court stated that the SEC could “regulate non-deceptive activities as a ‘reasonably designed’ means of preventing manipulative acts.”<sup>117</sup> The SEC could not, however, create rules that changed the meaning of “fraud.”<sup>118</sup> In order for an act to be manipulative, it must involve a nondisclosure or misrepresentation as required by § 10(b).<sup>119</sup>

Although the Supreme Court had not addressed Rule 14e-3's legitimacy, a number of circuit courts approvingly addressed this issue in the early 1990's. In *United States v. Chestman*,<sup>120</sup> the Second Circuit validated Rule 14e-3 as a proper use of § 14(e)'s rulemaking power for two reasons.<sup>121</sup> First, Rule 14e-3 was a “reasonably designed” means for preventing fraud under § 14(e), and second, § 14(e) gave the SEC the power to define fraudulent acts.<sup>122</sup> Two other circuits, the Seventh and the Fifth, also approved of Rule 14e-3.<sup>123</sup> These courts stated that it was a “reasonably designed” means of preventing fraud as outlined in § 14(e).<sup>124</sup>

Despite the acceptance of Rule 14e-3 by three different circuit courts, the Eighth Circuit became the first and only court to reject Rule 14e-3 in *United States v. O'Hagan*.<sup>125</sup> The Eighth Circuit said the rule was invalid because it did not require a fiduciary breach in order to be violated.<sup>126</sup> This decision created a split in the circuits concerning Rule 14e-3, which was subsequently remedied by the Supreme Court's *United States v. O'Hagan* decision.

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[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.” § 240.10b-5.

116. 472 U.S. 1 (1985).

117. *Id.* at 11 n.11.

118. *Id.*

119. *Id.* See also *Voves, supra* note 28, at 1031 n.99 (discussing the Court's finding that § 14(e) required nondisclosure just as § 10(b) required nondisclosure).

120. 947 F.2d 551 (2d Cir. 1991) (en banc).

121. *Id.* at 559-60.

122. *Id.* at 558. In approving § 14(e)'s delegation of fraud defining power to the SEC, the court said: “The statute explicitly directs the SEC to ‘define’ fraudulent practices . . . . It is difficult to see how the power to ‘define’ fraud could mean anything less than the power to ‘set forth the meaning of’ fraud.” *Id.* In approving Rule 14e-3 as a reasonably designed means, the court stated: “A delegation of authority to enact rules ‘reasonably designed to prevent’ fraud, then, necessarily encompasses the power to proscribe conduct outside the purview of fraud, be it common law or SEC-defined fraud.” *Id.*

123. See *S.E.C. v. Maio*, 51 F.3d 623 (7th Cir. 1995); *S.E.C. v. Peters*, 978 F.2d 1162 (5th Cir. 1992).

124. *Maio*, 51 F.3d at 635; *Peters*, 978 F.2d at 1167.

125. 92 F.3d 612, 627 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

126. *Id.* at 624.



II. SUBJECT OPINION: *UNITED STATES V. O'HAGAN*A. *Facts and Procedural History*

The defendant, James H. O'Hagan, was a partner at the law firm of Dorsey & Whitney in Minneapolis.<sup>127</sup> In 1988, Grand Metropolitan retained Dorsey & Whitney to represent it in a possible tender offer for Pillsbury Co.<sup>128</sup> O'Hagan did not work on the Grand Met matter himself, but he apparently knew of Grand Met's possible tender offer for Pillsbury Co.<sup>129</sup> In August and September of 1988, while Dorsey & Whitney still represented Grand Met, O'Hagan purchased call options and common stock in Pillsbury Co.<sup>130</sup> On September 9, 1988, the firm withdrew its representation of Grand Met.<sup>131</sup> On October 4, 1988 Grand Met announced its tender offer for Pillsbury Co., after which the price rose from \$39 per share to \$60 per share.<sup>132</sup> O'Hagan then exercised his options at \$39 per share and sold all of his stock and options in Pillsbury for \$60 per share.<sup>133</sup> O'Hagan made a profit of about \$4.3 million from the above transactions.<sup>134</sup>

The SEC then began an investigation into O'Hagan's trading which resulted in a fifty-seven count indictment against him.<sup>135</sup> The United States District Court for the District of Minnesota convicted O'Hagan on all 57 counts of mail fraud, securities fraud and money laundering.<sup>136</sup> The Court of Appeals for the Eighth Circuit subsequently reversed the convictions, stating that the misappropriation theory was not a valid extension of § 10(b), and Rule 14e-3 exceeded the power given to the SEC under § 14(e).<sup>137</sup> The Eighth Circuit rejected the idea that § 14(e) gave the SEC the power to define fraudulent.<sup>138</sup> According to the court, the statute only allowed the SEC to prohibit acts that fell within § 14(e)'s definition of fraud and that the court was to

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127. *United States v. O'Hagan*, 117 S. Ct. 2199, 2205 (1997).

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.*

133. *O'Hagan*, 117 S. Ct. at 2205.

134. *Id.*

135. *Id.*

136. *Id.*

137. *Id.* at 2206.

138. *United States v. O'Hagan*, 91 F.3d 612, 624-25 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997). The court remarked: "A straightforward exercise in statutory construction then affords no basis for concluding that § 14e authorizes the SEC to create its own definition of fraud." *Id.* at 624.

look to § 10(b) for help in defining fraud.<sup>139</sup> The court found that fraud under § 10(b) required a breach of a common law fiduciary duty; therefore, fraud under § 14(e) also required a breach of a fiduciary duty.<sup>140</sup> Rule 14e-3, however, does not require a breach of a fiduciary duty for a finding of a fraudulent act, and the court found this flaw to be fatal to the rule's validity.<sup>141</sup> The Supreme Court granted certiorari and decided the case on June 25, 1997.<sup>142</sup>

### B. *The Majority Opinion*

In a 6 to 3 opinion, the Court held that criminal liability under Rule 10b-5 could be predicated on the misappropriation theory.<sup>143</sup> In a 7 to 2 opinion the Court held that Rule 14e-3 was a permissible use of the SEC's rulemaking power under § 14(e).<sup>144</sup>

#### 1. *Rule 10b-5 and the Misappropriation Theory*

Justice Ginsburg, writing for the Court, first addressed the question of liability under Rule 10b-5 when based on the misappropriation theory.<sup>145</sup> According to past caselaw, liability under Rule 10b-5 cannot extend beyond conduct encompassed by § 10(b)'s prohibition.<sup>146</sup> The Court used the "classical theory" of insider trading as an example of fraud that is prohibited by § 10(b).<sup>147</sup> The "classic" corporate insider has a duty to disclose nonpublic information to shareholders in order

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139. *Id.* at 624-25. The court noted that in *Schreiber* the Supreme Court said to look to § 10(b) when determining fraud under § 14(e). *Id.* Thus, the Eighth Circuit looked to caselaw interpreting fraud under § 10(b). *Id.*

140. *Id.* at 624-25.

141. *Id.* at 624. ("[T]he SEC exceeded its rulemaking authority by enacting rule 14e-3(a) without including the requirement of a breach of a fiduciary duty.")

142. *Id.*

143. *United States v. O'Hagan*, 117 S.Ct. 2199, 2206 (1997). Justice Ginsburg wrote the majority opinion on the misappropriation theory in which Justices Stevens, O'Connor, Kennedy, Souter and Breyer joined. *Id.* at 2204. Justice Scalia dissented from the majority's opinion concerning the misappropriation theory. *Id.* at 2220. Justice Thomas, joined by Chief Justice Rehnquist, also dissented from the majority's opinion on the misappropriation theory. *Id.*

144. *Id.* at 2219. Justice Ginsburg wrote the majority opinion on Rule 14e-3 in which Justices Stevens, O'Connor, Scalia, Kennedy, Souter and Breyer joined. *Id.* at 2204. Justice Thomas, joined by Chief Justice Rehnquist, dissented from the majority's opinion concerning Rule 14e-3. *Id.* at 2220.

145. *Id.* at 2206.

146. *Id.* at 2207. The Court cited both *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 214 (1976), and *Central Bank v. First Interstate Bank*, 511 U.S. 164, 173 (1994), for the proposition that liability under Rule 10b-5 cannot exceed § 10(b)'s prohibition. *O'Hagan*, 117 S. Ct. at 2207.

147. *O'Hagan*, 117 S. Ct. at 2207. Under the classical theory, a corporate insider trades in the shares of his company based on nonpublic material information that the trader has obtained. *Id.* The Court has found this type of trading to constitute a "deceptive device" under § 10(b) because the insider and the shareholders have "a relationship of trust and confidence." *Id.* This relationship creates a duty to disclose on the part of the insider in order to prevent the insider

to prevent the insider from taking unfair advantage of other stockholders.<sup>148</sup> The misappropriation theory provides that a person commits fraud "in connection with" a securities trade when he uses nonpublic information in a trade and does not disclose the use of this information to his information source.<sup>149</sup> The trader breaches a duty owed to the source of his information when the trader does not disclose the use of the nonpublic information to his source.<sup>150</sup> This duty of loyalty and confidentiality arises from the fact that the source of the information has exclusive use of the information as a property right.<sup>151</sup> Thus, the trader's undisclosed use of this information for his own profit defrauds the principal-source of the exclusive use of that information.<sup>152</sup> Using this reasoning, the Court found that the misappropriation theory, like the classical theory, requires a deception or fraud through nondisclosure when there is a fiduciary duty requiring disclosure.<sup>153</sup> Under this analysis, the misappropriation theory meets the "fraud" requirement of § 10(b).

The Court proceeded to address the "in connection with" requirement of § 10(b). The Court stated that § 10(b) requires that the misappropriator's deceptive use of information be "in connection with" a securities transaction.<sup>154</sup> It found that this requirement was met because the fiduciary's fraud was not consummated until the trader used the nonpublic information to purchase or sell securities without disclosing the use of the information to the source.<sup>155</sup> The securities trade and the breach of duty coincide and therefore, the fraud is "in

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from taking unfair advantage of uninformed trading parties. *Id.* See *supra* note 9 and accompanying text.

148. *Id.*

149. *O'Hagan*, 117 S. Ct. at 2207. See *supra* notes 12-13 and accompanying text.

150. *O'Hagan*, 117 S. Ct. at 2207.

151. *Id.* The Court noted that in *Carpenter v. U.S.*, 484 U.S. 19 (1987), it had determined that a company's confidential information is property to which the company has exclusive use. *O'Hagan*, 117 S. Ct. at 2207. See *supra* notes 85-88 and accompanying text for a discussion of this case.

152. *O'Hagan*, 112 S. Ct. at 2207.

153. *Id.* The Court stated: "In lieu of premising liability on a fiduciary relationship between the company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." *Id.* The Court also noted, however, that full disclosure by the trader to his source of information would foreclose liability under the misappropriation theory because the deception or fraud essential to the theory is based on the trader pretending to be loyal to the source of information. *Id.* at 2209.

154. *Id.* at 2209.

155. *Id.* See *Chiarella v. United States*, 445 U.S. 222, 233 (1980) (stating that mere possession of nonpublic information is not a breach of a fiduciary duty). See *supra* notes 68-71 for a discussion of this case.

connection with” a securities transaction.<sup>156</sup> The Court also pointed out that § 10(b) does not require deception of an identifiable purchaser or seller, but rather just a deception in connection with a securities transaction.<sup>157</sup>

The Court further elaborated on the “in connection with” element, stating that the misappropriation theory targets information that is ordinarily used to gain risk-free profits from securities transactions.<sup>158</sup> The targeted type of nonpublic information ordinarily derives its value from use in securities trading.<sup>159</sup> Section 10(b) or the misappropriation theory, however, do not prohibit uses of nonpublic information that are unrelated to securities transactions.<sup>160</sup> The Court concluded that the theory is consistent with the policy concerns underlying § 10(b) because it helps to insure honest securities markets and promote investor confidence through disclosure.<sup>161</sup>

## 2. *The Scope of § 14(e) and the Validity of Rule 14e-3*

The Court then discussed Rule 14e-3 and its validity. In a 7 to 2 opinion the Court held that Rule 14e-3 was a valid exercise of the SEC's rulemaking power under § 14(e),<sup>162</sup> basing its acceptance of Rule 14e-3 on the proposition that it is a “reasonably designed” means of preventing fraud in this genre of cases.<sup>163</sup> The Court refused to address the question of whether the SEC has broader power to define “fraud” under § 14(e) than it does under § 10(b).<sup>164</sup>

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156. *O'Hagan*, 117 S. Ct. at 2209. The Court stated that the person defrauded need not be the other party to the transaction because a fraud can be practiced on one person with resultant harm to another person. *Id.*

157. *Id.* at 2210.

158. *Id.* at 2209. “The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.” *Id.*

159. *Id.* at 2210. The Court rejected the Government's contention that the targeted information only has value from use in securities transactions. *Id.* It said to replace “only” with “ordinarily” and the Government's characterization of the type of information to be regulated would be correct. *Id.*

160. *Id.* at 2209.

161. *Id.*

162. *O'Hagan*, 117 S. Ct. at 2214.

163. *Id.* at 2217.

164. *Id.* at 2215-17. The majority opinion stated: “We need not resolve in this case whether the Commission's authority under § 14(e) to ‘define . . . fraudulent’ is broader than the Commission's fraud-defining authority under § 10(b).” *Id.* at 2217. The Court acknowledged that in *Schreiber* it had stated that “manipulative” in § 14(e) has the same meaning as it does in § 10(b), which requires a showing of misrepresentation or nondisclosure for an act to be considered “manipulative”. *Id.* The Court also noted that § 14(e)'s anti-fraud prohibition was modeled on § 10(b)'s antifraud provision which requires that there be a duty to disclose arising from a fiduciary relationship. *Id.* at 2216.

In finding Rule 14e-3 to be a reasonably designed means of preventing fraud, the Court first noted that § 14(e) allows the SEC to proscribe acts that are not fraudulent under the common law or § 10(b) if the prohibition is reasonably designed to prevent fraud.<sup>165</sup> In deciding if the rule is reasonably designed, the Court stated that it must give the SEC's judgment "more than mere deference," because § 14(e) was passed by Congress.<sup>166</sup> Thus, the Court must give the SEC's determination "controlling weight unless [it is] arbitrary, capricious or manifestly contrary to the statute."<sup>167</sup> In this case, the Court decided that the SEC's determination was not arbitrary, capricious, or manifestly contrary to the statute.<sup>168</sup> To support this conclusion, the Court stated that it was fair to assume that trading based on nonpublic information will often involve a breach of a duty of confidentiality and that this breach will be nearly impossible to prove.<sup>169</sup> The Court went on to assume that the SEC was aware of this proof problem and, therefore, drafted Rule 14e-3 without requiring proof of a breach of a duty to disclose.<sup>170</sup> Thus, the Court concluded that Rule 14e-3 was a valid use of § 14(e)'s rulemaking power as applied to this genre of cases.<sup>171</sup>

### C. Justice Scalia's Dissenting Opinion

Justice Scalia dissented only from the majority's opinion concerning the validity of the misappropriation theory.<sup>172</sup> In a brief dissent, Justice Scalia stated that the principle of lenity,<sup>173</sup> which is applied to criminal statutes, required that the § 10(b) deception or manipulation be worked on a party to the securities transaction.<sup>174</sup> Since the misappropriation theory does not require that the deception or manipulation be worked on a party to the transaction, it is inconsistent with § 10(b) and the principle of lenity.<sup>175</sup>

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165. *Id.* at 2217.

166. *Id.*

167. *Id.* at 2217-18.

168. *O'Hagan*, 117 S. Ct. at 2218.

169. *Id.* at 2219.

170. *Id.*

171. *Id.*

172. *Id.* at 2220.

173. The rule of lenity is defined as a judicial doctrine that calls for the court to resolve an ambiguous criminal statute with multiple punishments in favor of the more lenient sentence. BLACK'S LAW DICTIONARY 557 (Pocket ed. 1996).

174. *O'Hagan*, 117 S. Ct. at 2220 (Scalia, J., dissenting).

175. *Id.*

*D. Justice Thomas' Dissenting Opinion*

Justice Thomas, joined by Chief Justice Rehnquist, dissented from the Court's opinion on both the misappropriation theory and the validity of Rule 14e-3.<sup>176</sup> Justice Thomas rejected the misappropriation theory because the Court's explanation of the theory's interpretation of the "in connection with" element was incoherent and inconsistent.<sup>177</sup> He also rejected Rule 14e-3 because the majority did not show that the rule was preventing any type of underlying fraud.<sup>178</sup>

In discussing the misappropriation theory, Justice Thomas did not dispute the majority's determination that an undisclosed use of non-public information by a fiduciary can constitute deception under § 10(b).<sup>179</sup> Rather, Justice Thomas believed that the Court's construction of the "in connection with" element was incoherent and therefore fatal to the theory's validity.<sup>180</sup> He claimed that the majority's "in connection with" analysis was actually based on the idea that a misappropriation of information is "in connection with" a securities transaction because the information only has value from use in a securities transaction.<sup>181</sup> The majority, however, rejected this idea as an "overstatement" on the part of the government.<sup>182</sup> In support of this contention, Justice Thomas pointed to the majority's classification of the misappropriation of funds for use in a securities trade as an act outside the scope of the misappropriation theory because the funds can be used for things other than a trade.<sup>183</sup> The fact that these funds have value to the trader outside of being used in a securities trade would bar liability based on the misappropriation theory because "the fraud would be complete as soon as the money was obtained."<sup>184</sup> Justice Thomas further pointed out that the misappropriation of nonpublic information has value outside of being used in a securities transaction.<sup>185</sup> The undisclosed misappropriation of information is

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176. *Id.* at 2220.

177. *Id.* at 2220-21 (Thomas, J., dissenting).

178. *Id.* at 2221.

179. *Id.* Justice Thomas stated that: "Nondisclosure where there is a pre-existing duty to disclose satisfies our definitions of fraud and deceit for purposes of the securities laws." *Id.*

180. *O'Hagan*, 117 S. Ct. at 2222.

181. *Id.*

182. *Id.* at 2210. The majority stated: "The dissent does catch the Government in overstatement. . . . [T]he Government urges that confidential information of the kind at issue derives its value only from its utility in securities." *Id.*

183. *Id.* at 2222.

184. *Id.*

185. *Id.* at 2223. Justice Thomas gave examples of uses of misappropriated information outside of the securities trading context. *Id.* The misappropriated information could be sold to a newspaper for profit, it could be sold to Pillsbury Company for profit, or it could be used for

not necessarily consummated by a securities transaction; therefore the misappropriation of information does not fall within the Court's construction of the "in connection with" element.<sup>186</sup>

Justice Thomas dissented from the majority's approach to the misappropriation theory for two additional reasons. First, Justice Thomas said that the majority's position was unacceptable because the Court created a new theory that the agency itself did not argue.<sup>187</sup> Justice Thomas further objected to the majority's substitution of "ordinarily" for the government's "only" in describing the amount of "connectedness" between the fraud and the securities transaction.<sup>188</sup> He stated that it is a fundamental principle that the Court cannot supply a basis for an agency's action that the agency did not proffer at oral argument.<sup>189</sup> Second, Justice Thomas dissented from the Court's opinion because of the misappropriation theory's weakness in furthering the policies underlying § 10(b) and Rule 10b-5.<sup>190</sup>

Justice Thomas also dissented from the majority's opinion on the validity of Rule 14e-3. He first stated that § 14(e) only allows the SEC to regulate fraudulent acts, and that it does not give the SEC the power to redefine "fraudulent."<sup>191</sup> Justice Thomas did agree with the

personal amusement in a fantasy stock trading game. *Id.* Justice Thomas concluded that this information therefore has value apart from being used in a securities transaction. *Id.*

186. *O'Hagan*, 117 S. Ct. at 2223-24. Justice Thomas noted:

That O'Hagan actually did use the information to purchase securities is thus no more significant here than it is in the case of embezzling money used to purchase securities. In both cases the embezzler could have done something else with the property, and hence the Commission's necessary "connection" under the securities laws would not be met.

*Id.* at 2223.

187. *Id.* at 2224.

I need not address the coherence, or lack thereof, of the majority's new theory, for it suffers from a far greater, and dispositive, flaw: It is not the theory offered by the Commission. Indeed, as far as we know from the majority's opinion, this new theory has never been proposed by the Commission, much less adopted by rule or otherwise.

*Id.*

188. *Id.* "Thus, we are told, if we merely substitute 'ordinarily' for 'only' when describing the degree of connectedness between a misappropriation and a securities transaction, the Government would have a winner." *Id.*

189. *Id.*

190. *Id.* at 2225-26.

The majority's approach is misleading in this case because it glosses over the fact that the supposed threat to fair and honest markets, investor confidence, and market integrity comes not from the supposed fraud in this case, but from the mere fact that the information used by O'Hagan was nonpublic . . . . 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.*

191. *Id.* at 2227-28.

majority that § 14(e) allows the SEC to prohibit non-fraudulent acts as a reasonably designed means of preventing fraudulent acts.<sup>192</sup> The dissenters, however, found that Rule 14e-3 was not an exercise of § 14(e)'s prophylactic power.<sup>193</sup> Justice Thomas argued that the rule merely redefined the term "fraudulent" and this redefinition is not permissible under § 14(e).<sup>194</sup>

Justice Thomas then considered Rule 14e-3's validity if it had been designed as a prophylactic power. He concluded that the rule is not valid because the misappropriation that the rule is designed to prevent is not a "legitimate object of prevention" since the misappropriation theory is not valid under § 10(b).<sup>195</sup> The dissent further stated that even if the misappropriation theory was valid under § 10(b), Rule 14e-3 was not a reasonably designed means for preventing fraud because there are no particular difficulties in proving a breach of a fiduciary duty in the tender offer setting.<sup>196</sup>

### III. ANALYSIS

The first part of the analysis of *United States v. O'Hagan* concerns the misappropriation theory. This Note argues that the acceptance of the misappropriation theory is based more on policy considerations than precedent and that the theory will not be entirely effective in championing these policy concerns. More specifically, this Note argues that the Court's analysis of the "in connection with" element is both incomplete and breaks from precedent. The Court searches for and accepts a fiduciary breach, which historically has not been regulated by the securities laws, to validate the misappropriation theory. Next, this Note discusses the Court's acceptance of Rule 14e-3 as a valid use of § 14(e) rulemaking power, arguing that the Court uses a rational basis test to approve the rule. The Court does not closely examine Rule 14e-3; rather, it relies on the decisions of lower courts and the SEC. Finally, this Note asserts that the Court's opinion regarding Rule 14e-3 leaves many questions unanswered by limiting that part of the opinion to the specific facts of this case.

As stated earlier, the Securities Exchange Act of 1934 was created to prevent and, when possible, end abuses in the securities markets

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192. *O'Hagan*, 117 S. Ct. at 2228.

193. *Id.*

194. *Id.* Justice Thomas found that the rule did not "purport to be an exercise of the Commission's prophylactic power, but rather a redefinition of what 'constitute[s]' a fraudulent, deceptive, or manipulative act or practice within the meaning of Section 14e." *Id.*

195. *Id.* at 2228-29.

196. *Id.* at 2229.



through the policy of full disclosure to establish honest markets and enhance investor confidence.<sup>197</sup> The SEC, through the use of various provisions of the Act, has made progress in bringing about disclosure and curbing abuses in the securities markets.<sup>198</sup> The Supreme Court has played a vital role in defining and determining the scope and effectiveness of the SEC's efforts.<sup>199</sup>

In its latest securities regulation case, *O'Hagan*, the Court has tried to resolve novel issues in a manner that is consistent with the overarching policies of honest markets, investor confidence, and prevention of profiteering.<sup>200</sup> The Court's reasoning and decision concerning the misappropriation theory and Rule 10b-5 attempt to reach a desired result without altering precedent.

*A. The Misappropriation Theory: A Technical Hook on Which to Extend Liability*

The Court first addressed the misappropriation theory by discussing the § 10(b) requirement that a fraud must occur in order to have a § 10(b) violation. The Court found that this fraud could be effectuated by nondisclosure when there is a duty to disclose.<sup>201</sup> The duty to disclose in this case arose from the fact that the source of the information revealed nonpublic information that the source had an exclusive right to use.<sup>202</sup> Thus, the trader had a duty to inform the source before using the information because use of the information without disclosure deprives the source of his exclusive use of the information.<sup>203</sup> The dissenters agreed with the Court's reasoning on this point, and the point seems well-grounded in precedent.<sup>204</sup>

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197. *Central Bank v. First Interstate Bank*, 511 U.S. 164, 171 (1994).

198. See 15 U.S.C. § 78j(b) (1997); 15 U.S.C. § 78n(e) (1997); 15 U.S.C. § 78p (1997).

199. See *Central Bank*, 511 U.S. 164; *Carpenter v. United States*, 484 U.S. 19 (1987); *Dirks v. S.E.C.*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

200. See *O'Hagan*, 117 S. Ct. at 2209. "The theory is well-tuned to an animating purpose of the Exchange Act: to insure honest markets and thereby promote investor confidence." *Id.* The Court also held that "a fiduciary's undisclosed, self-serving use of a principal's information" was a violation of Rule 10b-5. *Id.* at 2207.

201. *Id.* at 2208-09.

202. *Id.* The Court relied heavily on the Court's decisions in *Carpenter*, 484 U.S. 19, and *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977).

203. *O'Hagan*, 117 S.Ct. at 2208-09.

204. See *id.* at 2209. The majority stated: "A company's confidential information, we recognized in *Carpenter*, qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in *Carpenter*, constitutes fraud." *Id.* See *id.* at 2221. Citing *Chiarella*, the dissent, said that undisclosed misappropriation of confidential information can constitute deception because "non-disclosure where there is a pre-existing duty to disclose satisfies our definitions of fraud and deceit for purposes of securities laws." *Id.*

The Court's opinion encountered difficulty with precedent when it discussed the "in connection with" requirement of § 10(b). Prior to *O'Hagan*, the seminal case on insider trading and the misappropriation theory was *Chiarella*.<sup>205</sup> In *Chiarella*, the Court specifically left open the question of the misappropriation theory's validity since it had not been presented to the jury.<sup>206</sup> The *Chiarella* Court, however, did state in dicta that the duty to disclose was grounded in the relationship between the parties to the transaction.<sup>207</sup> This statement implies that the fraud that occurs in connection with the trade must be between the parties to the transaction.

The *O'Hagan* Court maneuvered around this obstacle by claiming that the "between the parties to the transaction" statement was only a means to reject the notion that § 10(b) imposed a general duty to disclose on all market participants.<sup>208</sup> The Court stated that it would therefore limit the "between the parties" statement to that particular context.<sup>209</sup> The Court pointed out that the *Chiarella* Court had left the misappropriation theory question open and that four justices had voiced support for the theory.<sup>210</sup>

The Court was correct that the theory's validity was still an undecided issue, but it simply ignored the meaning of the "between the parties to the transaction" statement.<sup>211</sup> It attached no significance to the statement, presumably because it was a rather inconvenient problem for the Court. The *Chiarella* Court plainly stated that § 10(b) does not impose a general duty to disclose nonpublic information on all market participants.<sup>212</sup> The "between the parties to a transaction" statement does not merely clarify or emphasize the point that § 10(b) does not impose a general duty to disclose; it goes beyond this point by limiting the duty to specified people. The "between the parties" statement is a specific, descriptive statement whereas the other point is a general premise.

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205. *Chiarella v. United States*, 445 U.S. 222 (1980). See *supra* notes 68-71 and accompanying text.

206. *Chiarella*, 445 U.S. at 236.

207. *Id.* at 230 ("[S]uch liability is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction").

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

209. *Id.*

210. *Id.*

211. See *supra* notes 41-42 for an explanation of this statement.

212. *Chiarella*, 445 U.S. at 229. The Court provided an example demonstrating there is no general duty to disclose nonpublic information. *Id.* "Accordingly, a purchaser of stock who has no duty to a prospective seller because he is neither an insider nor a fiduciary has been held to have no obligation to reveal material facts." *Id.* The Court also stated: "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic information." *Id.* at 235.

The majority dismissed similar statements found in the *Dirks* opinion by finding that the *Dirks* Court was reiterating the same statements from *Chiarella*.<sup>213</sup> These comments, of course, were limited to dispelling the notion that § 10(b) created a general duty to disclose. The Court also gave little weight to a statement in *Central Bank* that implied that the duty to disclose was based on a relationship between the parties to a transaction.<sup>214</sup>

While the Court did not show much concern for precedent, it repeatedly stressed the importance of the policy considerations underlying § 10(b) and Rule 10b-5.<sup>215</sup> It emphasized the importance of securing honest markets and promoting investor confidence and the effectiveness of the misappropriation theory in securing these goals.<sup>216</sup> The Court's brief treatment of potentially adverse caselaw, apparently due to its inconvenient nature, implies that the Court knew what result it was headed for and that it did not want to get caught up in technical problems caused by precedent. Knowing its desired result, the Court attempted to work within the established framework of Rule 10b-5 by showing that the misappropriation theory met the required elements for a violation.<sup>217</sup> Fitting the misappropriation theory into the established framework proved somewhat difficult, however, as highlighted by the Court's analysis of the "in connection with" requirement. The majority stated that the § 10(b) fraud need only be in

213. See *O'Hagan*, 117 S.Ct. at 2212-13.

214. See *Central Bank v. First Interstate Bank*, 511 U.S. 164, 191 (1994). The Court stated that:

Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming . . . the requirements for primary liability under Rule 10b-5 are met.

*Id.* In *O'Hagan*, the Court stated that this passage was only meant to show that secondary actors are subject to primary liability under § 10(b) and Rule 10b-5. *O'Hagan*, 117 S. Ct. at 2213. The Court also downplayed the significance of *Central Bank* by saying that it was only a private civil action whereas the present case involved a criminal action. *Id.*

215. *O'Hagan*, 117 S. Ct. at 2207-11. "The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by outsiders to a corporation." *Id.* at 2207. The theory "catches fraudulent means of capitalizing on such information through securities transactions." *Id.* at 2209. "The Exchange Act was enacted in part 'to insure the maintenance of fair and honest markets,' . . . and there is no question that fraudulent uses of confidential information fall within § 10b's prohibition." *Id.* at 2209. "The theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence." *Id.* at 2210. "Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law." *Id.* at 2210. "In sum, considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10b . . ." *Id.* at 2210-11.

216. *Id.* at 2207-11.

217. *Id.*

connection with a securities transaction and that it did not have to be between the parties to the transaction.<sup>218</sup> While this interpretation was purportedly based on the specific language of § 10(b), the Court's definition of the "in connection with" element is incomplete.<sup>219</sup>

The Court found that the misappropriation of nonpublic information is "in connection with" a securities trade because the misappropriation of this type of information is ordinarily valuable when used as the basis for a securities trade.<sup>220</sup> Unlike the misappropriation of nonpublic information, the misappropriation of money used to buy securities is not "in connection with" the securities transaction because the money could be used for many other purposes and derives value from other uses.<sup>221</sup> The many uses and values of misappropriated money make it "sufficiently detached" from the trade to prevent it from being "in connection with" the trade.<sup>222</sup> At best, this is a definition of "sufficiently detached" and an explanation of what fails to qualify as "in connection with" a securities transaction. Unfortunately, it does not define the "in connection with" a securities transaction requirement.

Aside from being incomplete, the Court's opinion failed to provide a clear definition of the "in connection with" element. The embezzled money example implies that misappropriated nonpublic information falls under the misappropriation theory because it does not have value or utility outside of the securities transaction context.<sup>223</sup> While the Court admitted that misappropriated nonpublic information does have some value and use outside of the securities transaction context,<sup>224</sup> it did not place much significance on these other uses and merely stated that the use and value of this information is ordinarily found in a securities trade.<sup>225</sup> This explanation does not offer a workable distinction from the misappropriated money example which the Court found to be sufficiently detached for purposes of liability under

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218. *Id.* at 2210.

219. See 15 U.S.C. § 78n(j) (1997). "It shall be unlawful for any person . . . to use or employ[] in connection with the purchase or sale of any security." *Id.*

220. *O'Hagan*, 117 S.Ct. at 2210; see also *id.* at 2220 (Thomas, J., dissenting) (discussing the inadequacy of the majority's "in connection with" explanation).

221. *Id.* at 2209-10.

222. *Id.* at 2209; see also 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, 172 (1997) (discussing the weakness of the Court's argument about the difference between misappropriated money and misappropriated information).

223. *O'Hagan*, 117 S. Ct. at 2209-10.

224. *Id.* at 2210.

225. *Id.*

the misappropriation theory.<sup>226</sup> In lieu of a clear definition, the Court appears to have provided a value judgment regarding the maximum utility that something may have outside of its usefulness in a securities trade, while still being sufficiently connected to the transaction for the purposes of the misappropriation theory.

In conclusion, the majority's analysis of the "in connection with" element of § 10(b) contains flaws, but its general premise that the fraud need only be connected to the securities transaction is consistent with § 10(b)'s language.<sup>227</sup> The Court, however, did not have to give a literal reading to § 10(b); it could have comfortably relied and built upon the *Chiarella* precedent and required that the duty to disclose arises from relationships between parties to the transaction.<sup>228</sup> Certainly reliance on precedent would have avoided the problems the Court faced in defining the "in connection with" element, but it would have also limited the liability and reach of Rule 10b-5.

Arguably, the Court did not follow the invitation extended by *Chiarella* because of its heavy reliance on policy considerations.<sup>229</sup> The Court's desire to promote the underlying policies may have been due in large part to the particular facts of this case.<sup>230</sup> In trying to properly deter activities like O'Hagan's, the Court needed to harmonize § 10(b)'s language and the *Chiarella* precedent, which states that § 10(b) does not impose a general duty to disclose.<sup>231</sup> Therefore, the majority was forced to find a fiduciary breach in order to extend liability.<sup>232</sup>

The strained expansion of liability by the *O'Hagan* Court is not fully effective in achieving the goals of the SEC, § 10(b) and Rule 10b-

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226. See *supra* notes 145-61.

227. 15 U.S.C. § 78j(b) (1997).

228. See *Chiarella v. United States*, 445 U.S. 222, 230 (1980). The Court stated that "such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction." *Id.*

229. See *supra* notes 68-71 (explaining the invitation offered by *Chiarella*).

230. The defendant, O'Hagan, was an attorney who used his position to make a \$4.3 million profit off of unsuspecting sellers of Pillsbury stock. *O'Hagan*, 117 S.Ct. at 2119-2202. See *supra* notes 127-42 (recounting the facts of this case).

231. See *Chiarella*, 445 U.S. at 233.

232. *O'Hagan*, 117 S. Ct. at 2207-08. The fiduciary breach that the Court relies on is based on the misappropriation of information by one who is entrusted with this information. *Id.* at 2207. Though this misappropriation involves deception in that the appropriator uses the information without telling the owner of the information, this type of conduct has not been the subject of federal law. *Id.* Rather it has generally been regulated by state law. *Id.* In *Santa Fe Indus. v. Green*, however, the Court said that corporate mismanagement and other state regulated conduct was not the proper subject of § 10(b). 430 U.S. 462, 478-79 (1977). See also Krawiec, *supra* note 222, at 173-74 (noting that *O'Hagan* probably "runs afoul" of *Santa Fe*, and that the requisite breach under the misappropriation theory is unrelated to the policy concerns of the securities laws).

5. The Court stressed that the misappropriation theory remains consistent with the policy concerns of assuring honest markets and investor confidence.<sup>233</sup> On the other hand, the majority admits that if the trader discloses to his source of information that he is going to trade based on the nonpublic information, then there is no liability under the misappropriation theory.<sup>234</sup> Thus, the disclosure by the trader prevents a § 10(b) fraud because there is no breach of the duty to disclose.<sup>235</sup> Although disclosure changes the trade from fraudulent to non-fraudulent, the adverse effects on the markets and investor confidence remain unchanged: the trader is able to gain a windfall at the expense of other market participants. While the Court points to the fact that a principal can seek equitable relief under state law once the trader has announced his intentions,<sup>236</sup> time considerations and financial expense may prevent the principal from seeking this relief.

The theory also falls short when a trader receives nonpublic information in the form of a tip from an insider if the trader has no knowledge of the insider's breach of a fiduciary duty.<sup>237</sup> If a trader receives a tip from an insider who has not breached a fiduciary duty then the trader will not be held liable.<sup>238</sup> Additionally, it is also possible that a person could overhear or happen upon nonpublic information and make a trade based on that information. Once again, there would be no violation based on the misappropriation theory, but the adverse effect on the market would be the same.<sup>239</sup>

There is no good explanation for the difference in treatment between the "duty-less" trader and the trader bound by a fiduciary duty. The resulting harm to policy considerations from each type of trader is the same, and it is the promotion of these policies that is the goal of § 10(b) and the *O'Hagan* ruling. After *O'Hagan*, the focus is shifted from fiduciary duties and subsequent breaches to the promotion of

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233. *O'Hagan*, 117 S.Ct. at 2210.

234. *Id.* at 2211 n.9. There is no liability "when a person trading on the basis of nonpublic information has disclosed his trading plans to, or obtained authorization from, the principal—even though such conduct may affect the securities markets in the same manner as the conduct reached by the misappropriation theory." *Id.*

235. *Id.* at 2208-09. "To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure." *Id.* at 2208; see Krawiec, *supra* note 222 at 173.

236. *O'Hagan*, 117 S. Ct. at 2211 n.9.

237. *United States v. Chiarella*, 445 U.S. 222, 230 n.12. (1980).

238. *O'Hagan*, 117 S. Ct. at 2212-13. The majority in discussing the *Dirks* case commented: "Absent any violation by the tippers, there could be no derivative liability for the tippee." *Id.*

239. *Id.* at 2211. "There is 'no 'general duty between all participants in market transactions to forgo actions based on material, nonpublic information.'" *Id.* See Krawiec, *supra* note 222, at 172-74 (discussing the general ineffectiveness of the misappropriation theory in preventing insider trading).

honest securities markets and investor confidence.<sup>240</sup> A court following this ruling and applying the misappropriation theory, however, must look to the existence of a breach of a fiduciary duty as a technical hook on which to extend liability. While this theory is consistent with the letter of the law and earlier decisions, it is not the most effective means to accomplish the goals of the law.

*B. The Court's Willing Acceptance of Rule 14e-3: The Advancement of Policy Considerations*

The Court used a rational basis test to approve Rule 14e-3 as a valid weapon against insider trading in the tender offer context.<sup>241</sup> Unfortunately, the Court's reasoning on this issue lacks significant analysis. The majority first pointed to the dual nature of § 14(e) in that it gives the SEC both definitional and prophylactic rulemaking power in the tender offer setting.<sup>242</sup> The Court stated that it would not decide the question of the SEC's ability to define "fraudulent" under § 14(e), because the rule was a valid use of § 14(e)'s prophylactic rulemaking power.<sup>243</sup>

In support of this prophylactic power, the Court first cited Congressional intent to use the section as a means of protecting shareholders and ensuring that disclosure is the market norm.<sup>244</sup> The Court then cited *Schreiber* for the proposition that § 14(e)'s prophylactic rulemaking power gave the SEC wide latitude to regulate non-deceptive acts as a reasonable means of preventing fraudulent acts.<sup>245</sup> By

240. *O'Hagan*, 117 S. Ct. at 2210.

241. *Id.* at 2217. "[W]e owe the Commission's judgment 'more than mere deference or weight.'" *Id.* (quoting *Batterton v. Francis*, 432 U.S. 416, 424-26 (1977)).

242. *Id.* at 2215-16. Section 14(e) reads in part:

It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (1997).

243. *O'Hagan*, 117 S.Ct. at 2217.

We need not resolve in this case whether the Commission's authority under § 14(e) to "define . . . such acts and practices as are fraudulent" is broader than the Commission's fraud-defining authority under § 10b, for we agree with the United States that Rule 14e-3(a), as applied to cases of this genre, qualifies under Section 14(e) as a "means reasonably designed to prevent fraudulent trading."

*Id.*

244. *Id.* at 2215.

245. *Id.* at 2217.

design, Rule 14e-3 does not require a breach of a fiduciary duty to impose liability.<sup>246</sup>

Finally, the majority concluded that the Court must give more than mere deferential treatment to the SEC's judgment because Congress has authorized this agency to prescribe rules.<sup>247</sup> Thus, the Court used a minimum rationality test in evaluating Rule 14e-3 as a proper use of the SEC's rule promulgation powers. Not surprisingly, the majority approved the rule as a valid use of § 14(e)'s rulemaking authority.<sup>248</sup>

The Court merely accepted the proffered justification for the rule without much analysis. The government also argued that it was probable that this rule would reach trading in which a breach of a duty was likely to occur, but very difficult to prove.<sup>249</sup> The Court agreed and stated that there is a wide circle of people that have access to confidential information in the typical tender offer setting which "may lead to abuse."<sup>250</sup>

This reasoning hardly supports the contention that a breach is likely to occur in the tender offer setting, and it does not support the notion that this breach will be difficult to prove. To the contrary, the fact that there is a significant number of people involved in a tender offer transaction suggests that it would be easier to obtain proof of a breach of duty since there are more possible witnesses from which to gather evidence.<sup>251</sup>

The majority also failed to provide a guideline for what types of fraudulent acts Rule 14e-3 is meant to prevent. It limited its holding to the type of fraud charged against O'Hagan, without stating if the rule applied to other types of fraud.<sup>252</sup> This ruling leaves the extent of

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246. *Id.* at 2215. Rule 14e-3 "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a preexisting fiduciary duty." *Id.*

247. *Id.* at 2217.

248. *Id.* at 2219.

249. *O'Hagan*, 117 S. Ct. at 2218.

250. *Id.* The Court stated that "the availability of that information may lead to abuse." *Id.*

251. *Id.* at 2218 n.20. The Court used the example of a father providing a tip to his son and his son's wealthy friend about a tender offer. *Id.* The son borrows money from the wealthy friend and buys stock in the target company. *Id.* The Court reasoned that the father will want to protect his son and not testify against him. *Id.* The Court concluded that because the only parties to the transaction would want to protect each other, it would be difficult to prove a breach of a duty by the son. *Id.* This would make it impossible to extend liability in this case. It is not hard to imagine that a tipper would not be willing to protect a tippee if the tipper was facing possible criminal charges and had no familial connection to the tippee. There are also many examples of other crimes in which the only witnesses to the crime are the participants to the crime, yet the government must still meet a more stringent scienter requirement. *Id.*

252. *Id.* at 2219. The Court stated: insofar as it serves to prevent the type of misappropriation charged against O'Hagan, Rule 14e-3(a) is a proper exercise of the Commission's prophylactic power under § 14(e). *Id.*



liability under Rule 14e-3 undecided. The Court also failed to discuss why it is very difficult to prove a breach of duty in the tender offer setting for purposes of § 14(e), but not as difficult to prove a breach of duty for purposes of § 10(b) liability. In failing to address these issues, the Court gave great deference to the SEC in crafting a criminal regulation which requires very little scienter.<sup>253</sup> Aside from the majority's concern to provide the SEC as much "latitude" as possible to combat securities abuses, the Court failed to provide much support for its decision. Furthermore, the Court did not define the scope of liability under Rule 14e-3, except to say that it reaches the type of fraud charged against O'Hagan. These factors imply that the majority was more interested in reaching a particular result than in defining and explaining the scope of Rule 14e-3.

#### IV. IMPACT

##### A. *The Future of the Misappropriation Theory*

Approval of the misappropriation theory will extend liability under § 10(b) and Rule 10b-5. The central issue in insider trading cases where the trader-defendant is not a traditional insider focuses on whether the trader owed a duty to the source of his information. Very often the trader will owe a duty to the provider of his nonpublic information because confidential information is a property right that the provider has an exclusive right to use.<sup>254</sup> Thus, the trader's intention to use the principal's property requires disclosure to the principal.<sup>255</sup> This increased liability should make it easier to successfully bring charges against parties who trade in securities based on nonpublic material information serving as a more effective deterrent initially. This initial effect will probably give the impression that § 10(b) and the misappropriation theory are adequate in combating insider trading.<sup>256</sup>

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253. *Id.* at 2219. The majority said: "The SEC, cognizant of the proof problem that could enable sophisticated traders to escape responsibility, placed in Rule 14e-3(a) a 'disclose or abstain from trading' command that does not require specific proof of a breach of fiduciary duty." *Id.* This statement and the language of Rule 14e-3 imply that only a showing of negligence is needed to prove a criminal violation of Rule 14e-3.

254. *O'Hagan*, 117 S. Ct. at 2208.

255. *Id.*

256. In a recent Second Circuit case, the court of appeals upheld the defendant's conviction under the misappropriation theory by citing to the *O'Hagan* decision. *United States v. Cusimano*, 123 F.3d 83, 87 (2d Cir. 1997). The Second Circuit cited *O'Hagan* in determining that the misappropriation theory was a valid extension of § 10(b) liability. *Id.* The court, however, said that the breach of fiduciary duty did not occur when the defendant used the information to make a trade, but rather when he initially obtained the information. *Id.* at 87-88. This explanation differs from the *O'Hagan* decision. See 117 S. Ct. at 2209. This court also noted the

It is quite possible, however, for a trader to avoid liability under the misappropriation theory through disclosure.<sup>257</sup> It also possible for a tippee to avoid liability if he did not know of the tipper's breach of duty.<sup>258</sup> Thus, the rule will not be as effective as it initially appears.<sup>259</sup> Although the aim of the theory is in the right direction, its shortcomings result from the framework in which it operates.

Future courts may embrace a broader theory of liability similar to the one advanced by Justice Blackmun in his dissent in *Chiarella*.<sup>260</sup> The *O'Hagan* Court appeared very concerned with advancing the policy considerations that support the insider trading laws and a theory similar to Justice Blackmun's theory would be very effective in promoting these policies because it would call for the "disclose or abstain" rule in almost all instances. This would certainly promote the full disclosure goal of the Securities Exchange Act of 1934.<sup>261</sup>

Given the Court's ruling on the validity of Rule 14e-3, it also seems possible that Congress could amend § 10(b) to make it more like § 14(e). If this were the case, it would seem very likely that the SEC could draft a new Rule 10b-5 that would not specifically require proof of a breach of duty. Without the requirement of finding a breach of duty, the SEC could simply assume that a breach had occurred and impose liability, overcoming the shortcomings of the misappropriation theory.

### B. *The Uncertain Future of § 14(e) and Rule 14e-3*

In addition to the uncertainties of the misappropriation theory, the Court's treatment of § 14(e) and Rule 14e-3 leaves many unanswered questions. First, the Court did not decide if § 14(e) allowed the SEC to give "fraud" a broader definition than that found in § 10(b) or the

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*O'Hagan* Court's acceptance of Rule 14e-3 as a valid use of § 14(e)'s promulgation powers. *Cusimano*, 123 F.3d at 88.

257. *O'Hagan*, 117 S. Ct. at 2211 n.9.

258. See *Dirks v. S.E.C.*, 463 U.S. 646, 660 (1983). See *supra* notes 89-92 and accompanying text for a discussion of this case.

259. See Richard W. Painter et al., *supra* note 53, at 188-91 (discussing the shortcomings and uncertainty caused by the *O'Hagan* decision).

260. *Chiarella v. United States*, 445 U.S. 222, 246 (1980) (Blackmun, J., dissenting). Justice Blackmun declared that "it is unnecessary to rest petitioner's conviction on a misappropriation theory . . . . I think the petitioner's brand of manipulative trading, with or without such approval, lies close to the heart of what the securities laws are intended to prevent." *Id.* Justice Blackmun would not base the duty to disclose or abstain on the existence of a fiduciary duty, but rather on the fact that a person has access to confidential information that is not legally available to others. *Id.* In his view, any other rule would fall short of serving the purposes of the securities laws. *Id.* at 247-51.

261. See *Central Bank v. First Interstate*, 511 U.S. 164, 171 (1994) (describing the act's replacement of caveat emptor with full disclosure).

common law.<sup>262</sup> If the SEC is allowed such power, then the SEC would seem to have quasi-legislative powers to define criminal conduct since it would be able to define the term to meet its objectives. It is more appropriate to reserve to Congress the power to define and expand the definition of criminal conduct.

Second, the Court has provided very little guidance in determining when a § 14(e) promulgation is a reasonably designed means for preventing fraud. The majority was willing to allow the SEC to have almost free reign in deciding which of its rules are reasonably designed,<sup>263</sup> which means that the SEC has almost sole discretion in deciding when it will prohibit a non-fraudulent act for the sake of preventing some fraudulent act that might exist in the tender offer setting. This grants significant power to the SEC in its fight against insider trading in the tender offer setting.

This lack of guidance provided by the *O'Hagan* court can be seen in *S.E.C. v. Mayhew*,<sup>264</sup> which cited *O'Hagan* as authority for the proposition that Rule 14e-3 is a valid use of § 14(e)'s rulemaking authority.<sup>265</sup> The *Mayhew* court also cited *O'Hagan* for the proposition that Congress intended § 14(e) to be a "broad" antifraud remedy in the tender offer context.<sup>266</sup> The section of *O'Hagan* that the *Mayhew* court cites, however, is the Court's discussion of whether § 14(e)'s rulemaking power is broader than § 10(b)'s rulemaking power, and, as mentioned before, the Court refused to decide this point.<sup>267</sup> The *May-*

262. *O'Hagan*, 117 S. Ct. at 2217.

263. *Id.* The majority said it owed "the Commission's judgment 'more than mere deference.'" *Id.*

264. *S.E.C. v. Mayhew*, 121 F.3d 44 (2d Cir. 1997).

265. *Id.* at 49. The court of appeals cited *O'Hagan* as authority for the proposition that Rule 14e-3 is valid despite its lack of a requirement for a breach of a fiduciary duty. *Id.* The court stated:

The Supreme Court, in *United States v. O'Hagan*, . . . faced with a claim that Rule 14e-3 exceeded the Commission's authority under § 14(e) of the 1934 Act, recently upheld the validity of Rule 14e-3 which imposes liability on persons who trade on material, nonpublic information in connection with a tender offer *without regard* to whether the trader owes a fiduciary duty to respect the confidentiality of the information.

*Id.* (emphasis added).

266. *Id.* at 53. In this particular case, the court found the defendant liable under Rule 14e-3 for making a trade based on a tip. *Id.* The court said that the fact that there was a two month period in between the time the defendant received the tip (and purchased securities) and the actual tender offer did not bar liability under Rule 14e-3 because § 14(e) is to be interpreted broadly. *Id.* The court of appeals cited *O'Hagan* for the statement: "Moreover, liability can attach under § 14(e) even though there is a two month lag between the tip and the tender offer. Congress intended § 14(e) to be a broad antifraud remedy in the area of tender offers." *Id.*

267. *Id.* See *O'Hagan*, 117 S. Ct. at 2216-17. The Court considered both *O'Hagan's* argument that § 14(e)'s power was equal to § 10(b)'s power, and the *United States'* argument that § 14(e) should be read to give the SEC power to go beyond the common law definition of fraud. *Id.* After considering both sides, the Court stated: "We need not resolve in this case whether the

hew court relied on this portion of the *O'Hagan* decision despite its lack of clarity.<sup>268</sup> Thus, a lower court has relied on *O'Hagan* for support that § 14(e) is a "broad" antifraud remedy even though the *O'Hagan* Court did not attempt to define or limit the breadth of § 14(e).

Finally, the *Mayhew* court cited *O'Hagan* when discussing § 14(e)'s "in connection with" requirement,<sup>269</sup> using *O'Hagan's* explanation of § 10(b)'s "in connection with" requirement to try to explain its interpretation of § 14(e)'s "in connection with" requirement.<sup>270</sup> The *Mayhew* court said that the information used by the defendant "had no value whatsoever" outside of its use in a securities transaction, and therefore the "in connection with" requirement was satisfied.<sup>271</sup> Conversely, the *O'Hagan* Court stated that nonpublic information used in a securities transaction need not be devoid of all value outside of the transaction.<sup>272</sup> It is unclear from the *Mayhew* opinion whether that court realized or followed the *O'Hagan* court's statement that nonpublic information which is used in a transaction can have value outside of its use in that transaction.

Based on the decision of the *Mayhew* Court, it appears that the *O'Hagan* Court's opinion regarding § 14(e) and Rule 14e-3 will give lower courts the broad discretion in interpreting Rule 14e-3. The Court should attempt to more clearly define and limit the reach of § 14(e) and Rule 14e-3 in order to provide guidance to lower courts facing Rule 14e-3 questions.

#### CONCLUSION

Although the *O'Hagan* Court reached what appears to be a just result, its path to that result was circuitous and unclear. The Court strained to reach a semi-coherent misappropriation theory that extends liability in this case. A more workable and appropriate standard for insider trading may be to look at whether the trader used the inside information for a proper corporate purpose; if not, courts should

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Commission's authority under § 14(e) to 'define . . . such acts and practices as are fraudulent' is broader than the Commission's fraud-defining authority under § 10b." *Id.*

268. *Mayhew*, 121 F.3d at 53.

269. *Id.*

270. *Id.*

271. *Id.* The court of appeals stated: "The information had no value whatsoever except 'in connection with' Mayhew's subsequent purchase of securities in anticipation of the tender offer." *Id.* The court went on to cite *O'Hagan* stating: "Section 10b's 'in connection with' requirement satisfied, under misappropriation theory, where 'fiduciary's fraud is consummated . . . when, without disclosure to his principal, he uses the information to purchase or sell securities.'" *Id.*

272. *O'Hagan*, 117 S.Ct. at 2209-10.

impose liability. Regarding Rule 14e-3, the Court did not strain itself at all. Rather it refused to address one issue and then delegated authority to the SEC on another issue, leaving virtually untouched the question of Rule 14e-3's scope and definition.

The majority looked to the plain language of these statutes and used the statutory language as a justification for granting the SEC great power to fight insider trading.<sup>273</sup> Looking to the egregious facts of this case and the policy concerns underlying the securities laws, the court thought this extension would provide an effective tool for extending liability in insider trading cases.

While this case is "fair" from a policy standpoint, it is not sound from a legal standpoint. In both instances, the Court was guided by policy considerations aimed at attaining fairness in this particular case, rather than following the precedent established in previous insider trading cases.

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273. *Id.* at 2206-08 (discussing the language of § 10(b) and Rule 10b-5 and how the misappropriation theory fits within the statutory language); *see also id.* at 2214-16 (discussing the language of § 14(e) and Rule 14e-3 and the fact that this language gave the SEC appropriate discretion in fighting insider trading in the tender offer context).