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Comments

Is There Life After *Bryan*?: The Validity of Rule 10b-5's Misappropriation Theory

INTRODUCTION

Since the inception of the Securities Exchange Act of 1934 (the "1934 Act"),[1] the Securities and Exchange Commission (the "SEC") has gained appreciation for the potential of Section 10(b) of the 1934 Act and its offspring, Rule 10b-5, for combatting the use of inside information in securities transactions. From its humble origins, Rule 10b-5 has become the SEC's primary tool in waging this war. At the present time, a recent decision in the Fourth Circuit, which invalidated the misappropriation theory of culpability under Rule 10b-5, threatens the SEC's arsenal.

For fifteen years, the SEC has used the misappropriation theory to expand the scope of Rule 10b-5 to include within its ambit those who misappropriated confidential corporate information in breach of a duty of confidentiality and profited from the use of such information in securities transactions. The significance of the theory is its inclusion of those who are not traditional corporate insiders. Simply put, the theory brings certain "outsiders" within the range of Rule 10b-5.

The Fourth Circuit invalidated the misappropriation theory essentially on the ground that United States Supreme Court precedent conclusively determined that, in cases of nondisclosure, the fraud element of Rule 10b-5 has to be satisfied by a breach of a duty to disclose which is owed to the seller of securities. According to the Fourth Circuit, precedent establishes that

1. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1981).

the fraud element cannot be satisfied by a fraud occurring elsewhere in relation to the security transaction.

This comment first traces the evolution of Rule 10b-5 with respect to the traditional theory of culpability, and then discusses the outgrowth of the misappropriation theory. It next considers whether the Fourth Circuit was correct in concluding that the fraud element of Rule 10b-5, in context to criminal prosecutions, is definitively restricted to a breach of the duty to disclose or abstain in cases of nondisclosure. Analysis reveals that the Fourth Circuit's conclusiveness with respect to the definition of fraud in Rule 10b-5 was premature. Additionally, this comment examines the legislative history accompanying the enactment of Section 10(b) and the administrative history of the rule to answer the question: Did Congress and the SEC intend to specifically limit the concept of fraud to the security transaction? Answering this question in the negative, this comment next discusses whether Congress gave the SEC policy-making power with respect to defining the "who, what and where" aspects of the fraud element. Arguing that Congress gave the SEC such power, this comment contends that the misappropriation theory's concept of fraud is a permissible construction of Section 10(b) and a permissible administrative interpretation of Rule 10b-5. In conclusion, an argument is made that the judiciary should defer to the SEC's construction of Section 10(b) and its interpretation of Rule 10b-5 as the misappropriation theory is reasonable in light of the language of Section 10(b) and Rule 10b-5 and their respective legislative and administrative histories.

I. THE EVOLUTION OF SECTION 10(b) AND RULE 10b-5: THE TRADITIONAL VIEW OF RULE 10b-5 CULPABILITY AND THE MISAPPROPRIATION THEORY

Before the enactment of the Securities and Exchange Acts of 1933 (the "1933 Act")[2] and 1934, the federal government only had the mail fraud statute available to prosecute securities fraud.[3] In the wake of the stock market crash of 1929, Congress

2. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1981).

3. LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 3404 (1991). The mail fraud statute provides:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, . . . for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or

enacted anti-fraud legislation specifically directed at the securities markets. The anti-fraud provisions of the 1933 and 1934 Acts were aimed at the inequitable trade practices which were considered a cause of the loss of investor confidence which led to the stock market's malfunction in 1929.[4] Both Acts contain general anti-fraud provisions. The original version of Section 17(a) of the 1933 Act proscribed the use of fraud in the sale of securities.[5] Though the language of Section 17(a) could be interpreted to apply to buyers of securities, the SEC limited its enforcement of the statute to sellers of securities.[6] This point is significant in the development of Section 10(b) because Rule 10b-5 was promulgated by the SEC to fill the gap left by Section 17(a). Section 10(b) prohibits the "use [of] . . . any manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities.[7] Unlike Section 17(a), which is self-operative, Section 10(b) gives the SEC the authority to prescribe rules and regulations necessary to carry out Section 10(b)'s anti-fraud provisions

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> delivered by the Postal Service, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined not more than $1000 or imprisoned not more than five years, or both.

18 U.S.C. § 1341 (1994).

4. Joan K. Martin, *Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far?*, 61 ST. JOHN'S L. REV. 78, 86 (1986) (citing S. REP. NO. 47, 73d Cong., 1st Sess. 6-7 (1933)); *see also* S. REP NO. 792, 73d Cong., 2d Sess. 3 (1934).

5. Section 17(a) of the 1933 Act provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—(1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a). The words "offer or" were added in 1954.

6. LOSS & SELIGMAN, *supra* note 3, at 3410.

7. 15 U.S.C. § 78j(b). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality, or interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security 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.

to protect the public interest and investors.[8]

The SEC did not exercise its rule-making authority under Section 10(b) until 1942 when it promulgated Rule 10b-5.[9] Realizing that Section 17(a) of the 1933 Act only regulated sellers of securities, the SEC created Rule 10b-5 to prohibit individuals and companies from engaging in fraud in the *purchase and sale* of securities.[10] Rule 10b-5 effectively extended the anti-fraud regulation to buyers of securities.

Initially, courts restricted Rule 10b-5, in actions involving non-disclosure, to situations where a common law fiduciary duty existed between the parties to the transaction.[11] The fiduciary requirement was interjected into Rule 10b-5 analysis because, at common law, a seller does not have a duty to disclose material information concerning the transaction absent a duty to do so.[12] The fiduciary requirement effectively limited Rule 10b-5's application to corporate insiders defined as corporate directors, officers and major shareholders because only persons in these capacities were considered to be in a fiduciary relation with the shareholders of a corporation.[13]

The SEC, pursuant to the broad language of Rule 10b-5, attempted in *In re Cady, Roberts & Co.*[14] to extend the reach of Rule 10b-5 beyond corporate insiders to include within its regulatory power "any person" who through a relationship with the

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8. *Id.*

9. Rule 10b-5 provides:

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

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

10. Martin, *supra* note 4, at 88 (citing SEC Securities Exchange Act Release No. 3230 (May 21, 1942)).

11. *Id.* at 89-90 (citing Birnbaum v. Newport Steel Corp., 193 F.2d 461, 464 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1953) and Kardon v. National Gypsum Co., 73 F. Supp. 798, 802-03 (E.D. Pa. 1947)).

12. Chiarella v. United States, 445 U.S. 222, 227-29 (1980).

13. Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65, 73-75 (1984).

14. 40 S.E.C. 907 (1961). In *Cady Roberts*, the SEC sought to enforce Rule 10b-5 on a securities broker who sold securities based on nonpublic material corporate information without disclosing the information. *Cady Roberts*, 40 S.E.C. at 907-10. The broker received the inside information from a director of the corporation. *Id.*

corporation had access to material confidential corporate information.[15] In *Cady Roberts,* SEC Chairman William Cary stated that the thrust of Rule 10b-5 is to address the "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."[16] He further stated that the reach of the SEC was not to be limited by "fine distinctions and rigid classifications" with regard to who it prosecuted.[17] Any person who had a "special relationship" with a corporation and was privy to its internal affairs is under a duty to disclose or abstain from trading.[18] Basing the duty of disclosure on a principle of fairness, *Cady Roberts* effectively relaxed the fiduciary requirements derived from the common law concept of fraud.

Following *Cady Roberts,* the courts deferred to the broadened scope of Rule 10b-5. The Second Circuit, in *SEC v. Texas Gulf Sulphur Co.*[19] and *United States v. Chiarella,*[20] accepted the *Cady Roberts'* view that the disclose or abstain rule could be based on a principle of fairness. The Second Circuit recognized that Rule 10b-5 was based on a policy that the investing public has expectations that all investors who trade through the impersonal securities market have equal access to material information.[21] According to the Second Circuit, the essence of Rule 10b-5 is one's access to confidential corporate information.[22] In

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15. *Id.* at 912.
16. *Id.*
17. *Id.*
18. *Id.*
19. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied,* 394 U.S. 976 (1969). In *Texas Gulf Sulphur,* the Second Circuit reversed the lower court's dismissal of a Rule 10b-5 criminal suit against a geologist who, while employed by a corporation to conduct exploratory drilling for mineral deposits in Canada, traded in the corporation's securities based on material confidential corporate information that indicated that a large mineral deposit was found. *Texas Gulf Sulphur,* 401 F.2d at 839-43, 852. Though the court did not find the geologist to be a director, officer or a shareholder, it considered him an "insider" by virtue of possessing the inside information. *Id.* at 847-48, 851.
20. 588 F.2d 1358 (2d Cir. 1978), *rev'd,* 445 U.S. 222 (1980). Chiarella was employed by a financial printing company as a "mark-up" man. *Chiarella,* 588 F.2d at 1362-63. His employer was hired to print documents dealing with takeover bids. *Id.* Though the bids were coded to hide vital information, Chiarella was able to deduce the name of the target corporation from the documents submitted to be printed. *Id.* Chiarella then bought stock in the target corporation before the takeover bid was made public. *Id.* The Second Circuit affirmed Chiarella's conviction under Rule 10b-5, holding that Chiarella violated Rule 10b-5 by breaching a duty of disclosure. *Id.* at 1364, 1373. The court based this holding on the principle that anyone, corporate insider or not, who possesses inside information assumes a duty to disclose the information before trading or must abstain from trading. *Id.* at 1365.
21. *Texas Gulf Sulphur,* 401 F.2d at 848.
22. *Id.*

this way, the Second Circuit held that the disclosure rule is applicable to persons who are not traditional insiders.[23]

The present-day problem facing the SEC with respect to the scope of Rule 10b-5 arose out of the Supreme Court's reversal of the Second Circuit's *Chiarella* holding. Considering the scope of Rule 10b-5 for the first time, the Supreme Court, in *Chiarella v. United States*,[24] reemphasized the requirements of the common law fiduciary duties in situations where an alleged violator of Rule 10b-5 remains silent in a stock transaction.[25] The Supreme Court observed that Section 10(b) does not state whether silence may be considered manipulative or deceptive.[26] However, the Court adopted the position that silence may be fraudulent if a party to a stock transaction was under a duty of disclosure via a fiduciary duty or similar relationship of trust and confidence with the other party to the transaction and failed to disclose before trading.[27] The Court stated that it could not affirm Chiarella's conviction unless it recognized a general duty placed on all market participants to disclose or abstain.[28] Without a congressional mandate, the Court refused to contravene the principles of common law fraud.[29]

The misappropriation theory originated in Chief Justice Burger's dissent in *Chiarella*. Chief Justice Burger recognized that as a general rule the parties to an arm's-length business transaction do not have a duty to disclose material information to the other party unless there is a fiduciary or confidential relation between them.[30] However, Chief Justice Burger argued that absent a fiduciary or fiduciary-like relationship, any person could still violate Rule 10b-5 if such person gained an informational advantage, not through industry and business acumen, but through an illegal act.[31] Under Chief Justice Burger's conception of the theory, when a person misappropriates inside information, the misappropriator assumes a duty to disclose or abstain.[32] According to Chief Justice Burger, a failure to adhere

23. *Chiarella*, 588 F.2d at 1365.
24. 445 U.S. 222 (1980).
25. *Chiarella*, 445 U.S. at 227-28.
26. *Id.* at 230.
27. *Id.*
28. *Id.* at 233.
29. *Id.*
30. *Chiarella*, 445 U.S. at 239-40 (Burger, C.J., dissenting).
31. *Id.* at 240.
32. *Id.* Chief Justice Burger derived his misappropriation theory from a law review article written by Page Keeton. The Chief Justice quoted Keeton to establish a link between the misappropriation and the duty to disclose or abstain:

[T]he way in which the buyer acquires the information which he conceals from

to this duty constitutes a violation of Rule 10b-5.[33]

The SEC made an argument based on the misappropriation theory in *Chiarella,* but the Supreme Court did not consider whether Chiarella was culpable for violating Rule 10b-5 under the theory because the issue was not submitted to the jury.[34] Justice Stevens, concurring in *Chiarella,* noted that "legitimate arguments" could have been made for and against liability under the misappropriation theory.[35]

To regain the ground that it had lost with respect to the scope of Rule 10b-5 in *Chiarella,* the SEC, in later cases, advanced the misappropriation theory of culpability under Rule 10b-5. The theory has been adopted in the Second, Third, Seventh and Ninth Circuits.[36] The circuits which have adopted the theory, however, have not accepted the expansive scope suggested by Chief Justice Burger in his *Chiarella* dissent, preferring to apply the misappropriation theory only to misappropriations involving a breach of a fiduciary duty or a duty of confidentiality.[37] This limitation excludes those who access confidential information through industrial espionage and theft without a concomitant breach of a fiduciary or fiduciary-like duty.[38] Typically, the SEC has advanced the misappropriation theory in cases involving an employee's breach of a duty of confidentiality owing to an employer and the employer's corporate clients.[39] However, the the-

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> the vendor should be a material circumstance. The information might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgement; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part. . . . Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.

Id. (quoting Page Keeton, *Fraud—Concealment and Non-disclosure,* 15 TEXAS L. REV. 1, 25-26 (1936)).

33. *Id.* at 240-41.

34. *Id.* at 235-37.

35. *Chiarella,* 445 U.S. at 238-39 (Stevens, J., concurring).

36. *See* United States v. Newman, 664 F.2d 12 (2d Cir.), *aff'd after remand,* 722 F.2d 729 (2d Cir. 1981), *cert. denied,* 464 U.S. 863 (1983); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985), *cert. denied,* 481 U.S. 1017 (1987); SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), *cert. denied,* 502 U.S. 1071 (1992); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990).

37. LOSS & SELIGMAN, *supra* note 3, at 641.

38. *Id.*

39. *See Newman,* 664 F.2d at 15 (applying the misappropriation theory to a securities trader and manager of the over-the-counter trading department of a New York brokerage firm); *Cherif,* 933 F.2d at 405-06 (applying the misappropriation theory to a former bank employee); *Clark,* 915 F.2d at 441 (applying the misappropriation theory to a president of a corporation which produced and sold medical supplies); United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986) (applying the misappropriation theory to a reporter for a financial newspaper), *aff'd,* 484 U.S. 19 (1987); SEC v. Materia, 745 F.2d 197 (1984) (applying the misappropriation theory to an

ory has been used in situations occurring outside the employment context.[40]

Because a mere breach of a fiduciary duty will not satisfy the fraud element of Rule 10b-5,[41] proponents of the misappropriation theory have argued that fraud is present in the misappropriation of confidential corporate information. The circuit courts which have adopted the theory have analyzed the fraud element with various degrees of precision.[42] The most analytic and precise analysis focuses on the employee's express or implied representation to an employer that the employee will uphold a duty of confidentiality and not use the entrusted information to the employee's benefit.[43] The Ninth Circuit noted:

> [B]y becoming part of a fiduciary or similar relationship, an individual is implicitly stating that she will not divulge or use to her own advantage information entrusted to her in the utmost confidence. She deceives the other party by playing the role of the trustworthy employee or agent; she defrauds it by actually using the stolen information to its detriment.[44]

This conception of the fraud element under the misappropriation theory arguably satisfies the elements of common law fraud in the following way: The misappropriator makes a false representation, either expressly or impliedly, to the employer concerning the material fact of the employee's willingness to uphold the duty of confidentiality; the employee knows of the falsity of the representation and makes the representation to induce the reliance of the employer; and the employer justifiably relies and is consequently harmed by the misappropriation. The Fourth Circuit, in part, found the misappropriation theory problematic with respect to the materiality and scienter requirements.[45] These elements are discussed in Section II of this comment.

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employee of a financial printing company), *cert. denied*, 471 U.S. 1053 (1985).

40. *See* United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.) (applying the misappropriation theory to a father and son relationship), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985); United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990) (applying the misappropriation theory to a psychiatrist-patient relationship).

41. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473 (1977) ("The language of sec. 10b gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

42. *See, e.g.*, *Newman*, 664 F.2d at 17. The *Newman* court stated: "[W]e need spend little time on the issue of fraud and deceit. . . . [T]he defendant "misappropriated—stole to put it bluntly valuable nonpublic information entrusted to him in the utmost confidence." *Id.* (quoting *Chiarella*, 445 U.S. at 245 (Burger, C.J., dissenting)).

43. *Clark*, 915 F.2d at 448.

44. *Id.*

45. *See* United States v. Bryan, 58 F.3d 933, 949 n.14, 950 n.16 (4th Cir. 1995).

To satisfy the harm element of common law fraud, the SEC has advanced the argument that the employer and the employer's corporate clients have been injured. For example, the argument has been advanced that a financial printer[46] and an investment banking firm[47] suffered injury when their reputations as safe repositories for corporate confidential information had been sullied by misappropriation. The corporate clients of employers have also been found to have been injured by the misappropriation. The circuit courts have alluded to the principle that corporate information is property to a corporation to which it has an exclusive right.[48] When the inside information is misappropriated, the corporation is injured by losing the exclusive right to the information. This argument gains support in *Carpenter v. United States*,[49] in which the Supreme Court established that a company can have a property right in corporate information under the mail fraud statute.[50] Additionally, in takeover situations, a corporate client that is an acquiring company can be injured by the misappropriation of information by virtue of the inflation of the value of the target stock which rises due to increased market activity.[51]

To justify locating the fraud outside of the security transaction, the circuit courts have liberally interpreted the "in connection" language of Section 10(b) and Rule 10b-5.[52] Though the employer and the employer's corporate clients take no part in the security transaction, the courts have based culpability on the fact that the information used in the security transaction originated from the defrauded employer and corporate clients.[53]

This concept of the fraud element of Rule 10b-5 is markedly different than that advanced by Chief Justice Burger in his *Chiarella* dissent. The circuit courts have located the fraud outside of the security transaction.[54] A plausible explanation for

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46. *See* SEC v. Materia, 745 F.2d 197, 202 (1984), *cert. denied*, 471 U.S. 1053 (1985).

47. *See* United States v. Newman, 664 F.2d 12, 17 (2d Cir.), *aff'd after remand*, 722 F.2d 729 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

48. *Clark*, 915 F.2d at 448-49 (citing Carpenter v. United States, 484 U.S. 19, 27-28 (1987)).

49. 484 U.S. 19 (1987).

50. *Carpenter*, 484 U.S. at 25-27.

51. *Newman*, 664 F.2d at 17.

52. *Id.* at 18. The Second Circuit stated: "[S]ince appellee's sole purpose in participating in the misappropriation of confidential takeover information was to purchase shares of the target companies, we find little merit in his disavowal of a connection between the fraud and the purchase." *Id.*

53. *Id.*

54. *Clark*, 915 F.2d at 445.

this change is that having failed to base the duty of disclosure on the principle of fairness as was tried in *Cady Roberts* and its progeny, and understanding the Court's reluctance to create a "federal fiduciary duty," the SEC looked elsewhere for the fraud.

In *Carpenter*, the Supreme Court had an opportunity to decide the validity of the misappropriation theory as a basis for criminal liability under Rule 10b-5.[55] However, the Court divided evenly on the issue of whether the conviction could be grounded on the misappropriation theory.[56] Thus, the conviction was affirmed. The legitimacy of the misappropriation theory was not settled, because a holding which issues from an evenly divided court has no precedential value.

II. *UNITED STATES V. BRYAN*

A. *The Invalidation of the Misappropriation Theory*

Until the Fourth Circuit's decision in *United States v. Bryan*,[57] the validity of the misappropriation theory was never seriously questioned. In *Bryan*, a director of the West Virginia State lottery used his position in the government to misappropriate confidential corporate information entrusted to the lottery commission in a bidding process to award contracts to supply video lottery machines to the state.[58] Knowing which video company would win the bid, Bryan bought stock in the company based on the non-public information.[59] Bryan was convicted of securities fraud under the misappropriation theory of Rule 10b-5.[60]

In reviewing the conviction, the Fourth Circuit did not content itself with the question of whether Bryan's conduct violated Rule 10b-5 under the misappropriation theory. Rather, the court went to the heart of the matter and asked whether criminal liability under Rule 10b-5 could be based on the misappropriation theory.[61]

The Fourth Circuit premised its analysis on essentially two principles. First, the fraud element of Section 10(b) and Rule 10b-5 require a misrepresentation or an omission to disclose when under a duty to do so.[62] The second principle, which is inter-

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55. *Carpenter*, 484 U.S. at 24.
56. *Id.*
57. 58 F.3d 933 (4th Cir. 1995).
58. *Bryan*, 58 F.3d at 938.
59. *Id.* at 939.
60. *Id.* at 943.
61. *Id.* at 945.
62. *Id.* at 946 (citing Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 470 (1977)

twined with the first, mandates that the fraud has to directly affect a purchaser or seller of securities.[63] The Fourth Circuit determined that the misappropriation theory allowed prosecution under Rule 10b-5 without satisfying either requirement.[64]

The Fourth Circuit based its narrow definition of fraud on precedent established in civil suits arising under Rule 10b-5.[65] In *Santa Fe Industries, Inc. v. Green*[66] and *Central Bank of Denver v. First Interstate Bank of Denver*[67] the Supreme Court defined the fraud element of Rule 10b-5 as the making of a material misrepresentation or the non-disclosure of material information when under a duty to disclose.[68] According to the Fourth Circuit, the Supreme Court, in *Dirks v. SEC*,[69] established this restricted definition of fraud in the criminal context of Rule 10b-5.[70]

To the Fourth Circuit, the misappropriation theory not only fails to satisfy this definition of fraud, it also does not involve

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and Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. 1439, 1448 (1994)).

63. *Bryan*, 58 F.3d at 945.

64. *Id.* at 944.

65. *Id.* at 946. Section 10(b) and Rule 10b-5 do not expressly provide for a civil action. The civil action was created in the seminal case of Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946).

66. 430 U.S. 462 (1977). In *Santa Fe*, minority shareholders brought a civil action, on the basis of Rule 10b-5, against a corporation to set aside a merger and to recover the fair value of their stock, alleging that the corporation fraudulently appraised the stock value when exercising its statutory right to buy out minority shareholders. *Santa Fe*, 430 U.S. at 462. Holding that Rule 10b-5 prohibits only acts which involve deception and finding no indication of manipulation in the acts of the defendants, the Court reversed the circuit court, which had concluded that Rule 10b-5 covers breaches of fiduciary duty that do not involve deception. *Id.* at 472-73, 479-80.

67. 114 S. Ct. 1439 (1994). In *Central Bank*, purchasers of certain bonds filed a Rule 10b-5 claim against the public building authority that issued the bonds, the bond's underwriters, the developer of the land in question and Central Bank as indenture trustee of the bonds after the building authority defaulted on the bonds. *Central Bank*, 114 S. Ct. at 1443. The central issue of the case was whether a claim of aiding and abetting can be made under Rule 10b-5. *Id.* at 1444. In concluding that such a claim cannot be asserted under the rule, the Court stated that "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act." *Id.* at 1448.

68. *Bryan*, 58 F.3d at 946 (citing *Santa Fe*, 430 U.S. at 472, 476 and *Central Bank*, 114 S. Ct. at 1448).

69. 463 U.S. 646 (1983). In *Dirks*, a broker who specialized in insurance company securities obtained confidential corporate information from a former officer of an insurance company, that the company's assets were fraudulently overstated. *Dirks*, 463 U.S. at 646. The SEC prosecuted Dirks under Rule 10b-5 for sharing this information with his clients who, after learning of the overstatement, sold their stock in the company. *Id. Dirks* is significant in the development of Rule 10b-5 case law for establishing the requisites for tippee liability.

70. *Bryan*, 58 F.3d at 946 (citing *Dirks*, 463 U.S. at 654).

conduct which is "fraudulent."[71] According to the Fourth Circuit, a misappropriation of inside information is more like a theft of information and merely a fiduciary breach which, in most cases, does not involve a misrepresentation or nondisclosure required under Section 10(b) and Rule 10b-5.[72] While the misappropriation of corporate information had been considered "fraudulent" under the mail fraud statute, the Fourth Circuit observed that the terms of Section 10(b) and Rule 10b-5 are "virtually" terms of art which prohibit such expansion.[73]

The Fourth Circuit found the misappropriation theory to be problematic with respect to the materiality and scienter requirements of common law fraud.[74] Presuming that the misrepresentation necessarily had to concern an investment decision, the court found that any misrepresentation involved in the misappropriation of information was meaningless with respect to Rule 10b-5 because it goes to the source of the information which was disconnected from the security transaction.[75] The Fourth Circuit's analysis of the scienter requirement was less precise, alluding to the fact that a promise to adhere to a fiduciary duty is different from a promise to perform an act in the future where the promise is part of the consideration for the sale of securities.[76] Conceivably, the Fourth Circuit considered the promise to be a faithful fiduciary a general promise which occurs prior to the formation of an intent to steal the information. According to this conception, the assumption of the duty of confidentiality is disjoined from the misappropriation and renders the misappropriation a mere breach of the duty of confidentiality without an intent to deceive.

In conjunction with restricting the definition of "fraud," the Fourth Circuit criticized the misappropriation theory for extending the reach of Section 10(b) and Rule 10b-5 to situations where neither the purchaser nor the seller of securities was defrauded.[77] The court found that the principle purpose of securities laws is to protect investors.[78] The misappropriation theory, according to the Fourth Circuit, ignores this limited congressional purpose by turning Section 10(b) from a law intended to protect market participants into a federal common law regulating all

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71. *Id.* at 949.
72. *Id.*
73. *Id.* at 952.
74. *Id.* at 949 nn. 14 & 16.
75. *Bryan*, 58 F.3d at 949-50 n.16.
76. *Id.* at 949 n.14.
77. *Id.* at 946-48.
78. *Id.* at 946-47.

trust relationships.[79] The Fourth Circuit cited *Chiarella* to support the contention that Section 10(b) and Rule 10b-5 only prohibit fraud directed at purchasers and sellers of securities.[80] The Fourth Circuit concluded that Section 10(b) and Rule 10b-5 extend, at most, only to other investors and persons with a similar interest in the actual transaction.[81]

Based on the narrow definition of fraud as a failure to disclose and on the interpretation of Section 10(b) and Rule 10b-5 that the fraud necessarily be on purchasers or sellers of securities, which follows from the limited definition of fraud, the Fourth Circuit rejected the misappropriation theory as a basis for criminal liability under Rule 10b-5.[82]

B. *The Shortcomings of* Bryan

In *Bryan*, the Fourth Circuit invalidated the misappropriation theory based on the erroneous notion that the Supreme Court in *Chiarella* and *Dirks* had conclusively defined the element of fraud, in context to criminal actions under Rule 10b-5, in terms of the failure to disclose or abstain when under a duty to do so. However, the Supreme Court did not speak definitively to preclude application of the misappropriation theory under Rule 10b-5. In *Chiarella,* the Court did not reach the issue of the validity of the misappropriation theory because it was not submitted to the jury. The Court reversed the conviction after conducting an analysis focused solely on the traditional theory of culpability. In *Dirks,* the Court made a general statement that an insider violates Rule 10b-5 "only where he fails to disclose material nonpublic information before trading on it and makes 'secret profits.'"[83] However, in *Dirks,* the Court made this statement in a general discussion of the traditional theory of fraud and did not directly confront the issue regarding the definition of fraud with respect to the misappropriation theory. The Supreme Court clearly has not spoken as definitively as the Fourth Circuit would lead one to believe with respect to criminal actions under Rule 10b-5.

To bolster its argument the Fourth Circuit relied on Supreme Court precedent concerning civil actions under Rule 10b-5. It is

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79. *Id.* at 950.

80. *Bryan*, 58 F.3d at 947 (citing *Chiarella*, 445 U.S. at 228).

81. *Id.* at 948.

82. *Id.* at 952-53. The Fourth Circuit also emphasized that misappropriators would be vulnerable to prosecution under Rule 10b-5, as interpreted by the Supreme Court in *Chiarella* and *Dirks*, and under the mail and wire fraud statute. *Id.* at 953.

83. *Dirks*, 463 U.S. at 654.

questionable whether the civil action should have such determining power over the criminal action because the civil action was not mandated by either the statute or the rule. A more palatable perspective is that a niche has been carved out for civil actions which in no way delimits the fraud element of the criminal action.

The differences between the civil and criminal actions with respect to who brings the action, and for what purpose, also makes the reference to the civil context tenuous. Typically, in civil actions under Rule 10b-5, a shareholder brings suit to recover the judicially created remedy. Two issues are integral to the civil action under Rule 10b-5: (1) the plaintiff must establish that he or she has standing or, in other words, has an interest in the suit because the plaintiff has been injured; and (2) the plaintiff must establish that the defendant had a fiduciary or similar duty to disclose the material information.[84] Thus, in civil cases of non-disclosure, the fraud element of the action is essentially defined by the disclose or abstain rule and must, therefore, directly affect the purchaser or seller who brings suit. However, the criminal action of Rule 10b-5 is not so defined. The SEC brings the action, so its burden is to prove that there was a fraud perpetrated in connection with a security transaction. The elements of the criminal action are not limited as is the plaintiff's in a civil suit because the statute and the rule do not specifically define how and where the fraud must occur.

The "in connection" language in Section 10(b) and Rule 10b-5 places some limitation on where the fraud takes place in relation to the security transaction. This issue introduces the question of the reasonableness of the misappropriation theory in light of Section 10(b) and Rule 10b-5, which is a different question, essentially, than the one asked by the Fourth Circuit in *Bryan*. The Fourth Circuit premised its analysis of the validity of the misappropriation theory on principles integral to civil actions and reasoned therefrom. Rejecting the applicability of these principles for want of legislative and administrative mandate and for want of Supreme Court guidance, analysis turns to the scope of the statute and the rule in the criminal context specifically. The scope of Section 10(b) and Rule 10b-5 is discussed in Section III of this comment.

The *Bryan* court refused to allow the analogy to the mail fraud statute, arguing that the purpose of the securities laws is differ-

84. SEC v. Materia, 745 F.2d 197, 202 (1984), *cert. denied*, 471 U.S. 1053 (1985).

ent than the mail and wire fraud statute and, therefore, concluded that the broad concept of fraud developed in the mail fraud context could not be used to define the "virtual terms of art" used in Section 10(b) and Rule 10b-5. However, similar to the mail fraud statute, Section 10(b) and Rule 10b-5, as drafted, are general anti-fraud provisions. The terms of Section 10(b) and Rule 10b-5 become "terms of art" when the presumption is made that the terms have been narrowly defined by *Chiarella, Dirks, Santa Fe* and *Central Bank*. Rejecting the conclusiveness of these Supreme Court cases on the issue of the scope of Rule 10b-5, the terms of Section 10(b) and Rule 10b-5 have yet to be defined sufficiently enough to render them "terms of art." In this respect, the analogy to the broad concept of fraud in the mail fraud context is valid.

The Fourth Circuit's analysis of the materiality requirement under the misappropriation theory can also be criticized for making a presumption that has not been definitively settled by the Supreme Court. The Fourth Circuit assumed that the fraud must be perpetrated on a purchaser or a seller. From this presumption, the Fourth Circuit reasoned that the fraud must bear on an investment decision. However, the field opens up after rejecting this premise. The materiality element can arguably be satisfied by a fraudulent misrepresentation concerning the willingness to uphold the duty of confidentiality with respect to material non-public corporate information.

The Fourth Circuit attacked the misappropriation theory, in part, for failing to satisfy the scienter element of fraud. To the court, the promise to be a faithful fiduciary usually does not involve deception. The Fourth Circuit, therefore, concluded that a misappropriation of information is merely a breach of a fiduciary duty. However, deception is surely present. The traditional theory established the scienter requirement in the circumstance where the insider had non-public information and intentionally failed to disclose the information in a securities sale to profit from an informational advantage. The misappropriation theory, on the other hand, bases the scienter requirement on the employee's intentional deception of the employer with respect to the employee's willingness to uphold the duty of confidentiality. When an employee makes a representation when beginning employment, either expressly or implicitly, that the employee will uphold a duty of confidentiality, the employee usually does not intend to misappropriate information at that time. The intent to steal information usually develops later. However, though made earlier in time, the representation does not have to be disjoined from the misappropriation. Conceiving the representation of will-

ingness to uphold the duty as continuing, the employee reasserts the willingness each time access to information is gained. When the employee accesses the information and forms an intent to misappropriate, a simultaneous deception and breach of the duty of confidentiality occurs. In this way, the misappropriation of inside information involves deception.

III. The Language of Section 10(b) and Rule 10b-5 and Their Respective Histories

Even the Fourth Circuit, in *Bryan,* recognized that the language of Section 10(b) and Rule 10b-5 is sufficiently general to accommodate the misappropriation theory.[85] Described as being "notoriously vague,"[86] Section 10(b) and Rule 10b-5 are sufficiently general in four respects: the language of the statute and rule encompasses "any person;" Rule 10b-5 uses the terms "any device, scheme, or artifice to defraud" and "any act, practice, or course of business which operates or would operate as a fraud or deceit" which extends to many practices; both the statute and the rule only require that the fraud occur "in connection with the purchase or sale of any security;" and Section 10(b) gives the SEC authority to regulate the securities market in the "public interest."[87] Responding to the general language of Section 10(b), the Supreme Court described the securities law as a "catch-all" anti-fraud provision.[88]

The legislative history accompanying the enactment of Section 10(b) provides little guidance in determining what Congress intended when it created the enabling statute.[89] An earlier version of Section 10(b), which was attached to the Senate Report that was sent to Congress to consider the final version, stated that it sought to protect "the interests of investors."[90] However, the final version of Section 10(b) did not retain this narrow scope. Instead, Congress gave the SEC the power to promulgate rules and regulations "as necessary or appropriate in the public interest or for the protection of investors."[91] With respect to the types of practices sought to be prohibited by the statute and its rules

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85. *See Bryan,* 58 F.3d at 945.
86. SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990).
87. *See supra* notes 7 and 9 for the texts of Section 10(b) and Rule 10b-5, respectively.
88. *Chiarella,* 445 U.S. at 226 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976)).
89. *Clark,* 915 F.2d at 450.
90. *Id.* at 450 n.19 (citing S. 3420, 73d Cong., 2d Sess. § 10b (1934)).
91. 15 U.S.C. § 78j(b).

and regulations, the Senate Report stated that "effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function.[92] Courts have referred to the "no useful function" language of the Senate Report to support the contention that Congress meant to define the scope of Rule 10b-5 broadly.[93]

The administrative history of Rule 10b-5 reveals that the SEC did not authorize the misappropriation theory at the time of the rule's promulgation nor, at that time, envision a need for it. Former SEC Assistant Solicitor Milton Freeman, who drafted the rule, has described the creation of Rule 10b-5 simply as a spontaneous response to the need for a provision prohibiting fraud in the purchase of securities.[94]

There is evidence that the SEC only contemplated protecting investors when it created Rule 10b-5. Following the adoption of the rule, the SEC issued a statement in which it announced that the rule prohibits individuals "from buying securities if they engage in fraud in their purchase."[95] Again, in its 1942 annual report, the SEC stated that the rule was adopted as "additional protection to investors."[96]

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92. *Clark*, 915 F.2d at 450 (citing S. REP. NO. 792, 73d Cong., 2d Sess. 6 (1934)).

93. *Id.*

94. Describing the circumstances out of which Rule 10b-5 arose, former SEC Assistant Solicitor Milton Freeman stated:

> I was sitting in my office in the SEC building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the SEC Regional Administrator in Boston, "and he told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase and sale" should be, and we decided it should be at the end. We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed around a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Milton Freeman, *Remarks before the Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

95. *Clark*, 915 F.2d at 450 n.21 (quoting SEC Release No. 3230 (May 21, 1942)).

96. *Id.* (quoting EIGHTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 10 (1942)).

Although the SEC statements concerning the adoption of the rule seemingly narrow the scope of Rule 10b-5 and foreclose the possibility of accommodating other interpretations regarding the scope of Rule 10b-5, such as the misappropriation theory, the unreflective and spontaneous act which created Rule 10b-5 suggests that the SEC had but a simple purpose in adopting the rule and did not intend to limit its scope. Moreover, the general grant of power given to the SEC in the enabling legislation suggests that Congress gave the SEC power to determine the scope of Rule 10b-5 over time to account for "unforseen species of fraud."[97]

Congress, on two later occasions, has made it clear that the misappropriation theory is consistent with Section 10(b) and Rule 10b-5. A 1984 House Report discussing the Insider Trading Sanctions Act of 1984, which amended the 1934 Act, stated that, "[s]ince its creation, the [SEC] has . . . appropriately used the antifraud provisions to remedy unlawful trading . . . by persons in a variety of positions of trust and confidence who have illegally acquired or illegally used material non-public information."[98] Referring specifically to misappropriation cases, the report stated:

> [I]n certain widely-publicized instances, agents of tender offerors and persons contemplating a merger or acquisition have used for personal gain information entrusted to them solely for a business purpose. Such conversion for personal gain of information lawfully obtained abuses relationships of trust and confidence and is no less reprehensible than the outright theft of nonpublic information.[99]

The report then stated that the misappropriation of confidential information has been held to be unlawful in other areas of the law and that "Congress has not sanctioned a less rigorous code of conduct under the federal securities laws."[100]

Congress again discussed the misappropriation theory when it considered enacting the Insider Trading and Securities Fraud Enforcement Act of 1988. Recognizing the *Carpenter* decision, in which the Supreme Court evenly split over the application of the misappropriation theory under Rule 10b-5, the House Committee voiced its support for the theory under Section 10b and Rule 10b-5.[101] Responding to a suggestion that the 1934 Act be amended

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97. *Id.* at 451.

98. *Id.* at 452 (quoting H.R. REP. NO. 355, 98th Cong., 2d Sess. 4 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277-78).

99. *Id.*

100. *Clark*, 915 F.2d at 452.

101. *Id.* (citing H.R. REP. NO. 910, 100th Cong., 2d Sess., 7, 11 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044, 6048).

to expressly create a private cause of action in order to preclude application of the misappropriation theory, the Committee emphasized the remedial purposes of the Act and found that the misappropriation theory fulfills the purpose of determining when trading on inside information is unlawful.[102]

Neither the language of Section 10(b) or Rule 10b-5 nor the respective legislative and administrative histories specifically limit the fraud element of Rule 10b-5 to the disclosure rule or to the security transaction. Additionally, subsequent congressional statements evidence the viability of the theory as a basis for criminal action under Rule 10b-5.

IV. JUDICIAL REVIEW OF ADMINISTRATIVE ACTIONS

A rule promulgated by an agency must be moored in the language of the enabling statute.[103] Enabling statutes, however, are often drafted broadly and, as a result, contain ambiguities.[104] The statutes are drafted broadly for a number of reasons. Realizing that it is impossible to precisely draft a statute that will account for the myriad of issues likely to arise under the statute, Congress drafts enabling legislation in general terms.[105] Also, lacking the time and expertise necessary to legislate in certain specialized areas, Congress delegates regulatory power to an agency which has both the time and knowledge necessary to create functional regulation.

The agency which administers the statute and the judiciary participate in giving meaning to an enabling statute.[106] When an agency adopts a rule pursuant to the enabling legislation, it gives the statute meaning.[107] The court then reviews the action of the agency to ensure that the rule accords with the standards set forth in the enabling statute.[108]

A. *Construction and Interpretation of an Enabling Statute*

At this point, it is important to make a distinction between an issue of policy and an issue of law which arises when an agency seeks to enforce a statute. The difference between the two types

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102. *Id.* (quoting H.R. REP. NO. 910 at 26-27, *reprinted in* 1988 U.S.C.C.A.N. at 6063-64).

103. KENNETH C. DAVIS & RICHARD J. PIERCE JR., ADMINISTRATIVE LAW TREATISE § 3.1 (3d ed. 1994).

104. DAVIS & PIERCE, *supra* note 103, § 3.1.

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

of issues is significant in that each requires different degrees of judicial deference.[109] The difference between an issue of policy and an issue of law reduces to the question: Did Congress resolve the issue in the enabling legislation?[110] If Congress has clearly spoken to the issue, a reviewing court is presented with an issue of law.[111] In this situation, Congress has provided the law and the agency and the judiciary must find and apply the law.[112] In such cases, the agency is only permitted to interpret the law as it is given and the reviewing court must ensure that the agency interpretation is reasonably grounded in the law. However, if Congress has left a gap for the agency to fill, the court is presented with an issue of policy. In this situation, the agency is given the power to construct the statute by making policy decisions.[113]

Administrative policy-making is acceptable as long as it stays within the bounds set by the enabling legislation.[114] The import of the distinction between an issue of law and an issue of policy is that a court must be more deferential in respect to an agency's policy decision than to a legal interpretation. When interpreting a statute, the judiciary ultimately decides the acceptability of the interpretation.[115] When a policy decision arises, however, it is the job of the agency, not of the courts, to decide which policy to follow.[116] When constructing a statute, the judiciary must avoid substituting its own policy preferences for the agency's.[117] The judicial branch of government has not been vested with the power to make such decisions.[118]

Section 10(b), drafted as broadly as it is, suggests that Congress intended to grant the SEC some policy-making power with respect to who can be prosecuted and what types of fraud securities laws prohibit. As a result of this orientation, the courts may have to proceed with more caution when considering the validity of the misappropriation theory under Rule 10b-5 in order to avoid substituting its own policy in lieu of the SEC's or to unduly restrict the SEC's power to make policy.[119]

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109. DAVIS & PIERCE, *supra* note 103, § 3.3.

110. *Id.* (discussing Chevron v. Natural Resources Defense Council, 467 U.S. 837 (1984)).

111. *Id.*

112. *Id.*

113. *Id.*

114. DAVIS & PIERCE, *supra* note 103, § 3.2 (quoting *Chevron,* 467 U.S. at 843-44).

115. *Id.* § 3.1.

116. *Id.* § 3.3.

117. *Id.*

118. *Id.*

119. Michael P. Kenny and Teresa D. Thebaut argue that the circuit courts

When a court reviews an agency action which involves a matter of policy-making and construction of a statute, it applies a two-step test:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.[120]

When Congress has expressly delegated the power to an agency to fill a gap in a statute, the agency is given authority to elucidate the provisions in the statute through regulation.[121] If the agency creates a rule pursuant to an expressed delegation, the regulation will be adjudged a "permissible construction of the statute" if it is not arbitrary, capricious, or manifestly contrary to the statute.[122] If Congress implicitly delegates power to an agency to fill a gap left in a statute, the court asks whether the regulation is reasonable in light of the enabling legislation to determine if such a regulation is a permissible construction.[123]

An analysis of the language of Section 10(b) reveals that Congress neither directly spoke to the issue of the scope of Section 10(b) nor expressly granted the SEC policy-making power to determine who may be prosecuted under the law, what type of fraud it sought to prohibit and where the fraud must occur in relation to a security transaction. Rather, the general terminology used in the enabling statute suggests that Congress intended to leave its scope broad and undefined. In this way, Congress implicitly granted the SEC policy-making authority to place limi-

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which have adopted the misappropriation theory have improperly imposed judicial policy on Section 10(b) and Rule 10b-5. Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139 (1995). On the contrary, the circuit courts which have recognized the theory have properly deferred to the SEC's reasonable construction of Section 10(b). The Fourth Circuit has improperly restricted the SEC's policy-making authority and, in effect, imposed judicial policy.

120. Chevron v. Natural Resources Defense Council, 467 U.S. 837, 842-43 (1984).

121. *Chevron*, 467 U.S. at 843-44.

122. *Id.*

123. *Id.*

tations, as it saw fit, on criminal actions arising under Section 10(b). To determine whether the misappropriation theory is a permissible construction of Section 10(b), a court must determine whether the misappropriation theory is reasonable with respect to the language and purpose of Section 10(b).

The misappropriation theory, as a policy determination, is clearly within the mandate of Section 10(b). It has been found that the misappropriation theory "fits comfortably" within the "notoriously vague" terms of Section 10(b) and Rule 10b-5.[124] The phraseology of "any person" and "in connection with the purchase or sale of any security" suggests that the fraud element of Section 10(b), and Rule 10b-5, can be established by conduct occurring outside of the security transaction. The legitimacy of the theory is buttressed by the "public interest" language of Section 10(b). The misappropriation theory discourages persons from stealing corporate information and makes for a more fair securities market. Moreover, though the fraud arises outside of the security transaction, the fraud involves inside information which is used in the security transaction. The seller of securities, therefore, is incidentally affected by the misappropriation. Thus, the concept of fraud integral to the misappropriation theory is sufficiently connected to the security transaction.

The argument that the misappropriation theory is invalid, in part, because its late introduction into the development of Rule 10b-5 fails to give the public notice of its restrictions,[125] is without merit. According to the principles of administrative policy-making, an agency is permitted to revise its conception of a statute or broaden it if such change is within the boundaries of the enabling legislation.[126] Clearly, the SEC did not, at the time of the early litigation under Rule 10b-5, realize Rule 10b-5's potential. The new concept of fraud developed under the theory can be considered an evolution of the rule. The misappropriation theory, rooted as it is in the language of Section 10(b) and Rule 10b-5, was always present in a latent form. The SEC has only recently begun to act on it.

When the *Bryan* court adjudged Section 10(b) as merely an instrument to protect investors and rejected the misappropriation theory, the court verged on judicial policy-making. Though a court must resolve the dispute before it, and must determine which of various policy arguments most adequately satisfy the enabling legislation, the court must have evidence before it to

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124. SEC v. Clark, 915 F.2d 439, 448-49 (9th Cir. 1990).
125. *Bryan*, 58 F.3d at 950-51.
126. DAVIS & PIERCE, *supra* note 103, § 3.5.

conclude that the agency's policy is unreasonable in light of the enabling legislation. The Fourth Circuit chose to reject the misappropriation theory on grounds supported by little legislative history and case treatment of Section 10(b) and Rule 10b-5 that did not absolutely restrict the scope of the Rule 10b-5, in its criminal dimension, to the "disclose or abstain" rule.

For the above stated reasons, it cannot be concluded that the misappropriation theory is an unreasonable policy decision of the SEC under Section 10(b).

B. *Judicial Review of an Agency's Interpretation of its Own Rule*

When an interpretation of an administrative regulation is presented to a court for review, the court must refer to the agency's interpretation of the regulation if the meaning of the terms are in doubt.[127] Congressional intent may determine the appropriate interpretation when various interpretations are advanced.[128] The Supreme Court has stated, however, that "the ultimate criterion is the administrative interpretation, which becomes of controlling weight unless it is plainly erroneous or inconsistent with the regulation."[129]

Judicial deference to an agency interpretation of its own rule is commonsensical. The agency is usually in a better position to determine the intended meaning and application of a regulation that it issued.[130] However, in the case of Rule 10b-5, there is scant administrative history to determine the intended meaning of the terms bearing on the fraud element. The story provided by Milton Freeman and the SEC statements in 1942 announcing the birth of Rule 10b-5 only reveal a lack of consideration with respect to the issue of the rule's scope. The SEC, at the creation of Rule 10b-5, simply intended to close a gap left by Section 17(a). It is reasonable to conclude that because the SEC did not seriously consider the scope of Rule 10b-5, it did not intend to restrict the meaning of the terms "any person," "defraud," "fraud and deceit" and "in connection with a purchase or sale" in any way.

The SEC did not authorize the misappropriation theory at the genesis of Rule 10b-5 but it also did not intend to preclude its application. To determine whether the SEC's interpretation of Rule 10b-5 is plainly erroneous or inconsistent with the regula-

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127. *Id.* § 6.10 (quoting Bowles v. Seminole Rock Co., 325 U.S. 410, 413-14 (1945)).

128. *Id.*

129. *Id.*

130. *Id.*

tion, inquiry must go elsewhere than to an intended meaning. The SEC's interpretation should be analyzed by the language of the rule itself. The question to be answered is whether the SEC's advocacy of the misappropriation theory is plainly erroneous or inconsistent with the wording of Rule 10b-5.

Though courts typically give deference to an agency's interpretation of its own rule under the "plainly erroneous or inconsistent" standard, courts will not defer to the agency interpretation if the regulation uses a common law term which is at issue or is a "disingenuous exercise in facesaving revisionism."[131]

1. The Lack of Judicial Deference to Agency Interpretations of Common-Law Terms

When an agency uses a common-law term in a regulation, deference is not required because the interpretation of the common-law term is not based on the expertise of the agency.[132] The judiciary is in a superior position to provide the interpretation of common-law terms.[133] If the agency seeks to apply another meaning than that traditionally applied by the common law, the notice requirement would be violated in that the rule under the desired interpretation becomes unpredictable.[134]

Because Rule 10b-5 uses the terms "defraud" and "fraud and deceit," the judiciary is not bound to defer to the SEC's interpretation of these terms. However, this is not cause for concern for the proponents of the misappropriation theory. The SEC does not seek to apply Rule 10b-5 in a way that changes the accepted meaning of the terms. As was discussed in Sections I and II.B of this comment, the fraud which occurs in the misappropriation of confidential corporate information satisfies the common law elements of fraud. The employee falsely represents to the employer a willingness to uphold the duty of confidentiality, to induce the reliance of the employer, and the employer justifiably relies on the employee's representation and consequently suffers harm.

The essential issue in the debate is the location of the fraud in relation to the security transaction. Because the language of Rule 10b-5 essentially tracks the language of Section 10(b), the agency interpretation of Rule 10b-5 involves the policy-making activity discussed above. The policy decision to broaden the scope of Rule 10b-5 to bring within its ambit persons who misappropriate non-

131. DAVIS & PIERCE, *supra* note 103, § 6.10.
132. *Id.* (citing Jicarrila Apache Tribe v. FERC, 578 F.2d 289 (10th Cir. 1978)).
133. *Id.*
134. *Id.*

public corporate information is not unreasonable in light of the inclusive language of Section 10(b). For similar reasons, the SEC's interpretation of Rule 10b-5 as including misappropriators cannot be said to be plainly erroneous or inconsistent with the regulation.

2. *"Disingenuous Exercise in Face-Saving Revisionism"*

If an agency interpretation is issued in suspicious circumstances and there is evidence that the agency adopted the opposite interpretation until it was subjected to public criticism, a court may reject the interpretation as a disingenuous interpretation done merely to save face.[135] Though the misappropriation theory was adopted late in the development of Rule 10b-5, it can hardly be held that this constitutes suspicious circumstances. Rather, the creation of the misappropriation theory is more aptly considered an evolutionary interpretation than a move to save power it irresponsibly lost through incompetence. Moreover, Congress has not criticized the SEC for advocating the misappropriation theory but has supported its application. As was discussed, there is evidence that early case treatment of Rule 10b-5 limited the scope of the rule to the disclose or abstain rule. However, this evidence does not establish that the SEC intended to absolutely limit Rule 10b-5 in such a way. Again, conceiving the birth of the misappropriation theory as an evolutionary growth of Rule 10b-5 and considering the "comfortable fit" of the theory to the rule's conceptual structure, the advocacy of the theory does not reek of desperation or face-saving.

V. CONCLUSION

After consideration, it is clear that the *Bryan* court was premature in sounding the death-knell of the misappropriation theory. The premise that the scope of Rule 10b-5 was limited by prior Supreme Court case law is simply incorrect. When the issue of the scope of Rule 10b-5 again appears before a court, the unsettled state of the law in this area must be recognized and the court must grant the SEC some degree of deference when constructing the statute and interpreting the rule. The misappropriation theory, at this point in the development of Rule 10b-5, must be judged by the language of Section 10(b) and Rule 10b-5 and their respective histories. That the language of Section 10(b) and

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135. *Id.* (citing Standard Oil Co. v. Federal Energy Admin., 453 F. Supp. 203, *aff'd,* 596 F.2d 1029 (Temp. Emer. Ct. App. 1978)).

Rule 10b-5 provide fertile ground for the theory and as the legislative and administrative histories do not reveal an opposing intent, it must be concluded that the misappropriation theory is a reasonable construction of Section 10(b) and is not plainly erroneous or inconsistent with Rule 10b-5.

Until the issue of the scope of Rule 10b-5 is settled by the Supreme Court, the SEC must decide whether to acquiesce in the Fourth Circuit's decision. Whether an agency must forego applying a particular interpretation, which has been rejected by a circuit court, in the very circuit which rejected the interpretation or in other circuits has not been definitively resolved.[136] Nonacquiescence is supported by numerous rationales. Judicial error, conflicting circuit court decisions, the high incidence of reversal, the newness of the issue, the Court's predilection to have the issue debated in other circuits after one circuit has overturned the interpretation, and the goal of national uniformity in application of regulations support the act of nonacquiescence.[137] It may be some time before the Supreme Court decides the issue of the validity of the misappropriation theory. In the interim, the SEC should not acquiesce in the Fourth Circuit's *Bryan* decision.

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136. DAVIS & PIERCE, *supra* note 103, § 2.9.
137. *Id.*