

RULE 10B-5 AND THE RISE OF THE UNJUST ENRICHMENT PRINCIPLE

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ABSTRACT

Securities regulation has traditionally focused on encouraging truthful disclosure that facilitates the accurate pricing of securities. A typical securities fraud claim under the primary antifraud provision, Rule 10b-5, must thus point to a misrepresentation or omission that is material to investors. At the same time, it is undeniable that Rule 10b-5 has been extended to conduct that does not fit this traditional conception of fraud, most notably insider trading. This Article shows that such deviations have become more common as Rule 10b-5 has increasingly become concerned with the problem of unjust enrichment. In numerous areas, the courts have applied Rule 10b-5 to deceptive conduct that is not directed at the market or investors but unjustly enriches some individual. Surprisingly, the unjust enrichment principle has functioned not only as an expander of liability but also as a limit. More and more, securities fraud class actions directed at market-distorting misrepresentations may only proceed if insiders have been enriched by the misrepresentation. The rise of the unjust enrichment principle demonstrates that securities regulation is not only concerned with the economic value of market efficiency but also is significantly influenced by public values. Securities regulation is guided by an evolving principle that sets some limits on the ability to extract wrongful gains from the securities markets. Though unjust enrichment is undeniably a concern of Rule 10b-5, it should be a second-order concern subordinate to the first-order concern of efficient markets.

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INTRODUCTION

According to the conventional account, securities regulation is based primarily on a policy of truthful disclosure.¹ Rather than regulating markets with a heavy hand, the securities laws facilitate the operation of efficient markets by encouraging the disclosure of accurate information. The Securities and Exchange Commission's (SEC) Rule 10b-5 is the primary legal enforcement mechanism that polices the truth of company disclosures to investors and the market.² Consistent with a disclosure regime, and despite its vague and expansive text, Rule 10b-5 has been mainly viewed as an antifraud rule.³ As Justice Lewis Powell declared in an often-quoted passage in

1. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 478 (1977) (“[O]nce full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute.”); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669 (1984) (“The securities laws . . . had and still have two basic components: a prohibition against fraud, and requirements of disclosure when securities are issued and periodically thereafter.”).

2. Rule 10b-5 reads:

Employment of manipulative and deceptive devices.

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

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

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

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2010).

Rule 10b-5 implements Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. §§ 78a–78oo (2006 & Supp. III 2009), which makes it unlawful “[t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” 15 U.S.C. § 78j(b) (2006).

3. See, e.g., *Dirks v. SEC*, 463 U.S. 646, 666 n.27 (1983) (“[T]o constitute a violation of Rule 10b-5, there must be fraud.”); David S. Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?*, 57 NW. U. L. REV. 627, 665 (1963) (“All three subsections of section 17(a) and Rule 10b-5 should be viewed as fraud sections and recovery should be allowed only in the event that the fraud can be discovered.”); Alan Strudler & Eric W. Orts, *Moral Principle in the Law of Insider Trading*, 78 TEX. L. REV. 375, 407 (1999) (“The idea of ‘fraud’ is important in insider trading law not only because the Supreme Court has recognized the concept as a limit to expanding liability, but also because ‘the proscription of fraud’ expresses one of the basic purposes of federal securities regulation.” (footnote omitted)); Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 409

Chiarella v. United States,⁴ “[s]ection 10 (b) is aptly described as a catchall provision, but what it catches must be fraud.”⁵ By punishing companies that mislead the market, Rule 10b-5 provides an additional incentive to comply with mandatory disclosure laws,⁶ helping create the foundations for an efficient securities market and protecting investors who rely upon such disclosures. Securities regulation is thus commonly seen as primarily promoting economic efficiency.⁷

Despite the cleanness of the efficient-markets conception of Rule 10b-5,⁸ the prohibition of insider trading has made it difficult to think of Rule 10b-5 as a rule exclusively concerned with fraud. Insider trading doctrine has developed in fits and starts because of the difficulty of characterizing insider trading as fraud.⁹ Indeed, despite the fact that they both originate from Rule 10b-5, insider trading and securities fraud doctrine are often treated as unrelated bodies of law. Unlike fraudulent statements directed at investors or the market, the primary wrong of insider trading is not market harm but rather the

(1990) (“[U]nderlying the Supreme Court’s rule 10b-5 cases is the image of a statute directed at nothing more than promoting candor and eliminating fraud.”).

Despite the doctrine developed by the courts, there are questions as to whether the legislative history of the securities laws supports the hegemony of the antifraud rule. *See, e.g.*, Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1068–88 (1995) (arguing that disclosure statutes addressed the problem of promoters who could unjustly enrich themselves through stock offerings); Thel, *supra*, at 460 (arguing that the Securities Exchange Act is directed in part at manipulation by speculators).

Moreover, there is an inevitable overlap between fraud prohibited by the federal securities laws and state corporate-governance issues. *See* James D. Cox, *Fraud Is in the Eyes of the Beholder: Rule 10b-5’s Application to Acts of Corporate Mismanagement*, 47 N.Y.U. L. REV. 674, 691 n.75 (1972).

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

5. *Id.* at 234–35; *see also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971) (“We agree that Congress by § 10 (b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement.”). For an analysis of Justice Powell’s role in shaping Rule 10b-5 doctrine, *see* A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L.J. 841, 930–45 (2003).

6. Of course, companies have reputational incentives to disclose truthful information. The market will likely punish the stock price of companies with management that routinely lies to the market.

7. *See, e.g.*, Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agency Paradox*, 2002 U. ILL. L. REV. 1, 10 (“[S]ecurities law . . . focuses primarily on the goal of economic efficiency in lieu of distributional objectives.”).

8. As Elizabeth Warren notes in the bankruptcy context, “clean” explanations are not always the best. *See* Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 811 (1987) (“I have offered a dirty, complex, elastic, interconnected view of bankruptcy from which I can neither predict outcomes nor even necessarily fully articulate all the factors relevant to a policy decision.”).

9. *See infra* Part II.A.2.

benefit extracted by the individual who wrongfully exploits inside information. Others have thus noted that insider trading can be described as a form of unjust enrichment,¹⁰ though there has been discomfort with extending Rule 10b-5 beyond its traditional focus on fraud.¹¹ Therefore, the insider trading prohibition and its link to unjust enrichment have largely been treated as an embarrassing but isolated anomaly in Rule 10b-5 doctrine.

This Article argues that, far from being an ancillary concern, the unjust enrichment principle has increasingly defined the scope of Rule 10b-5. Rule 10b-5 is becoming just as much an unjust enrichment rule as it is an efficient-markets rule. The Supreme Court's decision in *United States v. O'Hagan*¹² conclusively established that Rule 10b-5 could be directed at deceptions whose primary harm is unjust enrichment rather than fraud that hinders efficient markets.¹³ By adopting a misappropriation theory of insider trading, *O'Hagan* recognized that Rule 10b-5 is not limited to fraudulent statements directed at the market or investors. Instead, *O'Hagan* held that Rule 10b-5 can be triggered by deceptions directed at non-market participants, so long as those deceptions coincide with a securities transaction. In doing so, *O'Hagan* extended Rule 10b-5 to cover unjust enrichment that does not directly distort the market. In the wake of *O'Hagan*, the unjust enrichment principle has expanded the scope of Rule 10b-5 in a number of areas, including cases directed at broker-dealer misappropriation and mutual-fund market timing.¹⁴

10. See, e.g., WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 3.5.2 (2d ed. 1996) ("The public perception is that much stock market insider trading unjustly enriches the information possessor."); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 26 (1982) (asserting that the prohibition of insider trading is based on a principle that prohibits fiduciaries from unjustly enriching themselves); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1500 (1999) ("[M]any securities market participants view insider trading as the wholly unjust enrichment of those privy to significant confidential information."); Robert B. Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 VAND. L. REV. 349, 395-96 (1984) (observing that the "prohibition [of insider trading] is aimed at preventing insiders' unjust enrichment," not at compensating victims).

11. See, e.g., Strudler & Orts, *supra* note 3, at 407 ("But the unjust enrichment principle, taken as a full explanation of the prohibition against insider trading, would prove too much. If one accepted unjust enrichment as the basic justification for what is wrong with insider trading, there is no reason why the principle should apply only to the illegal acquisition or misuse of information.").

12. *United States v. O'Hagan*, 521 U.S. 642 (1997).

13. See *infra* Part II.B.2.

14. See *infra* Part III.

Securities fraud and insider trading doctrine in many ways have been unified by the unjust enrichment principle. In addition to its expansive influence with respect to insider trading, the unjust enrichment principle has also played a role in limiting the scope of Rule 10b-5 with respect to securities fraud class actions. Although the efficient-markets and unjust-enrichment conceptions of Rule 10b-5 have largely been two ships passing in the night, there has been tension between the two paradigms as courts have used the unjust enrichment principle to restrict the reach of securities fraud class actions. In determining whether a defendant in a securities fraud class action acted with scienter, the courts often require the plaintiff to allege that a defendant received a “concrete benefit” in order for the case to proceed.¹⁵ Some commentators have gone so far as to propose that only securities fraud class actions involving allegations of insider trading should be permitted.¹⁶ Thus, even in the context of punishing market-distorting fraud, courts often focus on the issue of unjust enrichment.

The rise of the unjust enrichment principle demonstrates that securities regulation is not solely concerned with technical efficiency concerns but also relates to targeting conduct that offends public values.¹⁷ Though it is an essential part of securities regulation, the danger of the unjust enrichment principle is its potential to divert the attention of Rule 10b-5 from its primary purpose: encouraging efficient markets. To check this tendency, it makes sense to think of Rule 10b-5 as having two distinct concerns. The first-order concern is to prohibit significant misstatements that distort the ability of the market to value a stock correctly. The second-order concern is to target unjust enrichment relating to misconduct that does not necessarily impact market prices but that offends the public values reflected by the unjust enrichment principle. Securities regulation not only helps markets function efficiently but also is guided by a

15. *See infra* Part IV.B.

16. *See infra* Part IV.C.

17. This distinction reflects ideas from an earlier article noting the contrast between an administrative approach that emphasizes cost-benefit analysis and a public-values approach. *See* James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 662–74 (2007) (contrasting the administrative and public-values approaches). In the antitrust context, there is a similar contrast between economic and political approaches to regulation. *Compare* Robert Pitofsky, *The Political Content of Antitrust*, 127 U. PA. L. REV. 1051, 1051 (1979) (emphasizing a political approach in conflict with an economic approach), *with* Daniel A. Crane, *Technocracy and Antitrust*, 86 TEX. L. REV. 1159, 1160 (2008) (preferring a technocratic approach over a populist, democratic approach).

principle that limits the extent to which wrongful gains can be extracted from the market.

Part I of this Article describes the dominant conception of Rule 10b-5 as an antifraud rule meant to facilitate efficient markets. Part II describes the evolution of insider trading doctrine so that it now reflects an unjust enrichment principle. Part III describes how the unjust enrichment principle has increased the substantive reach of Rule 10b-5 in a number of contexts. Part IV relates to the tension between the efficient-markets and unjust-enrichment conceptions of Rule 10b-5 in the context of the scienter standard, which is evolving in such a way that it focuses more and more on individual enrichment. Part V argues that Rule 10b-5 is best seen as having two concerns, a first-order concern relating to efficient markets, and a second-order concern relating to unjust enrichment. It argues that the rise of the unjust enrichment principle illustrates that securities regulation does more than further economic goals: it also reflects public values. In a world in which the public is increasingly focused on wrongful enrichment by market participants, Rule 10b-5 should play an important though limited role in punishing the worst forms of unjust enrichment relating to securities transactions.

I. RULE 10B-5 AS AN ANTIFRAUD RULE

As noted in the Introduction, securities regulation is centered on a truthful disclosure requirement,¹⁸ which is largely enforced through the antifraud provision set forth in Section 10(b) of the Securities Exchange Act of 1934¹⁹ and implemented by Rule 10b-5.²⁰ Because the SEC reviews only a small percentage of disclosures for accuracy and cannot verify most disclosed information,²¹ securities fraud actions brought pursuant to Rule 10b-5 are the main legal mechanism

18. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 477–78 (1977) (noting that the Securities Exchange Act of 1934 implements a “philosophy of full disclosure” (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1971))); Easterbrook & Fischel, *supra* note 1, at 670 (“The dominating principle of securities regulation is that anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain.”); Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 869–86 (2003) (describing the disclosure regime and its expansion).

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

20. 17 C.F.R. § 240.10b-5 (2010).

21. See STAFF OF S. COMM. ON GOVERNMENTAL AFFAIRS, 107TH CONG., FINANCIAL OVERSIGHT OF ENRON: THE SEC AND PRIVATE-SECTOR WATCHDOGS 10 (Comm. Print 2002) (noting that the SEC reviewed about 16 percent of the filings it received in 2001).

for policing the accuracy of periodic filings and disclosures.²² This Part traces the initial evolution of the theory and doctrine defining the scope of Rule 10b-5 securities fraud actions. Although the initial goal of prohibiting fraud was the protection of investors, the mandatory disclosure and antifraud regime is now primarily justified as a means of enhancing the efficiency of markets. Many of the Supreme Court's securities fraud decisions interpret Rule 10b-5 in a way that emphasizes the efficient-markets goal by narrowing the scope of securities fraud actions so that they mainly reach fraudulent statements that cause market distortions.

A. *Efficient Markets and Rule 10b-5*

In its early days, the primary goal of securities regulation was seen as protecting investors.²³ For example, the few early empirical studies assessing mandatory disclosure asked whether disclosure resulted in greater returns for investors.²⁴ Though investor protection still plays a significant role in securities regulation, the focus of protection has shifted from the investor to the market.²⁵ These developments are partly a result of the incorporation of financial theory into both the legal literature and doctrine. The ideal of an efficient market set forth a new role for Rule 10b-5 as a protector of markets.

22. In addition, there are other provisions providing a remedy for fraud in particular circumstances, such as the issuance of securities. *See* Securities Act of 1933 (Securities Act) § 11, 15 U.S.C. § 77k (2006).

23. *See, e.g.,* Herman & MacLean v. Huddleston, 459 U.S. 375, 390 (1983) (“Defrauded investors are among the very individuals Congress sought to protect in the securities laws.”); Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 336 (1979) (“[F]ew would disagree that the antifraud provisions tend to focus more on the role of protection than on the role of efficiency.”); Alan B. Levenson, *The Role of the SEC as a Consumer Protection Agency*, 27 BUS. LAW. 61, 61–62 (1971) (“If the Securities and Exchange Commission is to be viewed as a ‘consumer protection agency’ and, indeed, it was so designed by Congress, the consumers which it was designed to protect are the public investors.”); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1032 (1977) (“The SEC, however, has come to perceive the primary purpose of the securities laws to be the protection of investors, rather than improved resource allocation.” (footnote omitted)).

24. *See, e.g.,* George J. Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721, 725 (1964) (“The basic test [of disclosure] is simplicity itself: how did investors fare before and after the S.E.C. was given control over the registration of new issues?”).

25. *See, e.g.,* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 66 (1980) (“Antifraud rules, such as rule 10b-5, are designed to reduce the transaction costs of exchange.”).

Beginning in the 1960s, financial economists hypothesized that stock markets were efficient in that a stock price reflects all known information relevant to the value of the stock.²⁶ They produced evidence that stock prices followed an unpredictable random walk, indicating that a stock price reflects current information rather than being determined by patterns reflected in past stock prices.²⁷ The efficient-markets hypothesis distinguished between weak, semi-strong, and strong forms of efficiency.²⁸ The weak form of efficiency contends that future stock prices cannot be predicted by studying past stock prices.²⁹ The semi-strong form of efficiency contends that stock prices reflect all publicly available information about the issuer.³⁰ The strong form of efficiency contends that stock prices reflect all information, whether publicly available or not, about the issuer.³¹

Perhaps the first legal academic to extensively analyze securities regulation through the lens of the efficient-markets hypothesis was law and economics scholar Henry Manne. In an article following the 1966 publication of his controversial defense of insider trading, *Insider Trading and the Stock Market*,³² Manne notes that he failed to appreciate in his book that the link between insider trading and market efficiency was the strongest argument for allowing insider trading.³³ Manne argues that because insiders are in the best position

26. See, e.g., Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (reviewing a decade's worth of empirical research on efficient capital markets and stating that "[a] market in which prices always 'fully reflect' available information is called 'efficient'").

27. See Eugene F. Fama, *The Behavior of Stock-Market Prices*, 38 J. BUS. 34, 34–35 (1965) (explaining that data suggest that the random-walk theory is correct in that successive prices are independent and the price changes conform to some probability distribution).

28. Fama, *supra* note 26, at 383; see also Ronald J. Gilson & Reineir H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555 (1984) ("Eugene Fama's landmark 1970 review article first proposed the now-familiar division of the [Efficient Capital Market Hypothesis] into 'weak,' 'semi-strong,' and 'strong' forms as a device for classifying empirical tests of price behavior.").

29. See Fama, *supra* note 26, at 383.

30. See *id.*

31. See *id.*

32. HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966). In his book, Manne primarily argues that insider trading does not hurt long-term investors, *id.* at 77–110, and that insider trading is a way of compensating entrepreneurs, *id.* at 111–58.

33. See Henry G. Manne, *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547, 565 (1970) ("The efficient functioning of the stock market is actually one of the strongest arguments for unfettered insider trading, though at first blush it may appear to have little relationship to the issue at hand."); see also Hsiu-Kwang Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260, 266 (1968) ("Insider speculation

to assess the significance of new information that might impact a company's stock price, insider trading would increase the speed at which market prices accurately reflected new information.³⁴

By 1968, the economist Irwin Friend could declare: "The economic justification for disclosure, which is perhaps the most basic mechanism of securities regulation, is the belief that the provision of information to prospective investors is a necessary condition for efficient markets."³⁵ Before long, the SEC and its critics were also citing the efficient-markets hypothesis. A 1977 report by the Advisory Committee on Corporate Disclosure to the SEC discussed the efficient-markets hypothesis as a justification for mandatory disclosure rules.³⁶ In his 1979 book, *The SEC and Corporate*

performs an important function in the stock market; it increases both allocational efficiency and promotional efficiency.").

34. Manne, *supra* note 33, at 565–75. This conclusion has been questioned. Ronald Gilson and Reineir Kraakman note that trades by insiders in themselves may not transmit information to the market. See Gilson & Kraakman, *supra* note 28, at 629–31 ("Insiders trade because private information alters their expectations. But their trading will change the market's expectations about the security, and hence its price, only if their private information is somehow transmitted to the market.").

35. Irwin Friend, *The SEC and the Economic Performance of Securities Markets, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 185, 187 (Henry G. Manne ed., 1969); see also George J. Benston, *The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES, supra*, at 23, 26 ("Perhaps one of the most important arguments for requiring that accounting statements be disclosed is that they convey information that is required for the stock market to be efficient."); Levenson, *supra* note 23, at 62 ("The economic justification for disclosure as the keystone of investor protection lies in the belief that material corporate and financial information disseminated to prospective investors provides a rational basis to evaluate securities and this is a necessary precondition to efficient markets.").

36. STAFF OF H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REP. OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SEC, 644–47 (Comm. Print 1977). The report linked the disclosure system to the goal of creating efficient markets: "The system of corporate disclosure that emerged under the Securities Act and the Exchange Act can best be understood as one aspect of an essentially two-pronged regulatory approach that was designed to promote more efficient securities markets." *Id.* at 560.

In addition, the move to an integrated disclosure system by the SEC assumes an efficient market. See, e.g., Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 6235, 45 Fed. Reg. 63,693, 63,698 (Sept. 2, 1980) (premising the shelf-registration mechanism on an assumption that "investors are protected by the market's analysis of information about certain companies which is widely available, both from the Commission's files and other sources, and that such analysis is reflected in the price of the securities offered"); SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (THE WHEAT REPORT) 10, 48, 52, 54 (1969) (emphasizing the role of sophisticated investors and professionals in filtering information and the speed at which dissemination occurs).

Disclosure: Regulation in Search of a Purpose,³⁷ Homer Kripke takes a contrary view, using the efficient-markets hypothesis to critique the SEC's disclosure system. Kripke notes that if markets are efficient, it is unlikely that an amateur investor can take advantage of disclosures to find an undervalued stock because the investor cannot move quickly enough to take advantage of the information before it is reflected in the stock price.³⁸ Kripke also questions the importance of information summarizing past performance when stock prices are determined by future performance.³⁹ He acknowledges, however, that the mandatory disclosure system should not be abandoned because past financial information can be useful in analyzing the fundamental value of a stock.⁴⁰

Scholars also began linking the Rule 10b-5 fraud prohibition to the needs of an efficient market.⁴¹ Victor Brudney noted in 1979 that the goal of an antifraud provision “is to improve the efficiency of the market so that the price reflects value, and therefore financial, and ultimately real, resources will be optimally allocated.”⁴² Gregg Jarrell has noted that fraud would increase the information risk faced by investors.⁴³ Frank Easterbrook and Daniel Fischel have observed that “[f]raud reduces allocative efficiency” and “[a]ccurate information is

37. HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* (1979).

38. *Id.* at 86–87 (“[Efficient-market studies] point to a fundamental flaw in the SEC’s standard rhetoric that disclosure in its documents will enable the investor to make an informed judgment after he is appraised of all the facts. If a market layman or an unsophisticated market professional determined from those documents that a security were undervalued, he might or might not be wrong on the facts, but in any event he would be wrong on the timing.”).

39. *Id.* at 31–32.

40. *Id.* at 106–07.

41. In understanding the importance of the fraud prohibition, it makes sense to distinguish between informational and fundamental efficiency. *See, e.g.*, William K.S. Wang, *Some Arguments That the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 344–49 (1986) (defining informational efficiency as a state in which prices reflect all public information, whereas “fundamental-valuation” efficiency is a state in which “prices are based on the rational expectations of future payments to which the asset gives title”). A market is informationally efficient if stock prices quickly incorporate available information. A market is fundamentally efficient if stock prices accurately reflect the fundamental or true value of the stock. Mandatory disclosure may be enough if the only concern is informationally efficient markets. But if fundamental efficiency is the goal, a fraud prohibition is desirable to deter companies from issuing false information that hinders the ability of the market to reflect the fundamental value of the stock. To the extent that this Article refers to efficient markets, it is referring to markets that are fundamentally efficient.

42. *See* Brudney, *supra* note 23, at 334.

43. Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues*, 24 J.L. & ECON. 613, 635 (1981).

necessary to ensure that money moves to those who can use it most effectively and that investors make optimal choices about the contents of their portfolios.”⁴⁴ An antifraud rule could reduce verification costs and make it more costly for “low-quality firms to mimic high-quality ones by making false disclosures.”⁴⁵ John Coffee cites empirical evidence that federal securities laws reduced price dispersion and notes that the “most logical conclusion to draw from this evidence is that allocative efficiency was enhanced and that investors thereby benefited.”⁴⁶

The theoretical link between Rule 10b-5 and efficient markets became embedded in doctrine with the Supreme Court’s 1988 decision in *Basic Inc. v. Levinson*.⁴⁷ In *Basic Inc.*, the Court adopted a fraud-on-the-market theory,⁴⁸ under which reliance on a fraudulent misstatement relating to a publicly-traded company could be presumed because, in an efficient market, a stock price would reflect that misstatement.⁴⁹ The Court observed that “[r]ecent empirical studies have tended to confirm Congress’ premise that the market price of shares traded on well-developed markets reflects all publicly available information, and hence, any material misrepresentations.”⁵⁰ The Court thus firmly linked Rule 10b-5 and its fraud prohibition to a particular goal: the prevention of misrepresentations that might distort an efficient market.⁵¹

44. Easterbrook & Fischel, *supra* note 1, at 673.

45. *Id.* at 677.

46. John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 735–36 (1984). *But see* Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 838–46 (1995) (arguing that antifraud liability might reduce incentives to disclose).

47. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

48. Lower courts had adopted the fraud-on-the-market theory as early as 1975. *See, e.g.*, *Blackie v. Barrack*, 524 F.2d 891, 907 (9th Cir. 1975) (noting that an investor who purchases stock on an exchange “relies generally on the supposition that the market price is validly set and that no unsuspected manipulation has artificially inflated the price, and thus indirectly on the truth of the representations underlying the stock price—whether he is aware of it or not, the price he pays reflects material misrepresentations”); *see also* Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 9 (1982) (discussing the fraud-on-the-market theory); Note, *The Fraud-on-the-Market Theory*, 95 HARV. L. REV. 1143, 1154–56 (1982) (discussing the assumption that market prices respond to information that is or is not disseminated).

49. *Basic Inc.*, 485 U.S. at 241–49.

50. *Id.* at 246.

51. The Supreme Court’s use of the efficient-markets hypothesis in *Basic Inc.* has been controversial. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1060 (1990)

Although there has been controversy over whether markets are actually efficient,⁵² an antifraud rule that helps markets function efficiently rather than dictating behavior of public companies is a form of regulation attractive to those who do not typically favor regulation.⁵³ Thus, the antifraud rule has largely been spared the extensive efficiency critiques that economists level at other regulatory areas such as antitrust.⁵⁴ Scholars continue to defend securities regulation as an essential way of encouraging efficient markets.⁵⁵ Rule

(“[The Court’s adoption of the efficient capital markets hypothesis] suffers from analytic flaws that threaten to undermine its usefulness.”); Paul G. Mahoney, *Precaution Costs and the Law of Fraud in Impersonal Markets*, 78 VA. L. REV. 623, 623–25 (1992) (“[R]ejecting [fraud on the market] and requiring individualized proof of reliance as a prerequisite to recovery under Rule 10b-5 would most closely approximate optimal deterrence.”).

52. See Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 857–72 (1992) (describing behavioral economics critiques of the market-efficiency theory); Wang, *supra* note 41, at 344–49 (describing arguments that markets are not fundamentally efficient); see also Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 618 (1989) (arguing that the goal of efficient markets may be less important than assumed because stock markets do not play a significant role in allocating resources).

53. Easterbrook & Fischel, *supra* note 1, at 669 (noting that “[t]here is very little substantive regulation of investments” under the disclosure regime).

54. See, e.g., ROBERT H. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* 104–06 (1978) (discussing the “thoroughly misunderstood concept” of productive efficiency).

55. See, e.g., John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 230 (2007) [hereinafter Coffee, *Law and the Market*] (“[H]igher enforcement intensity gives the U.S. economy a lower cost of capital and higher securities valuations.”); Nicholas L. Georgakopoulos, *Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud*, 49 U. MIAMI L. REV. 671, 675 (1995) (“[F]raud-on-the-market is a desirable but incomplete development in securities fraud.”); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 713 (2006) (“[T]he ultimate goal of securities regulation is to attain efficient financial markets”); see also Marcel Kahan, *Securities Laws and the Social Costs of “Inaccurate” Stock Prices*, 41 DUKE L.J. 977, 979 (1992) (noting that the purpose of securities regulation is “to create stock markets in which the market price of a stock corresponds to its fundamental value”).

That is not to say there has not been controversy over the desirability of the current regime. Many have questioned whether the enforcement scheme is effective. See, e.g., John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1535–36 (2006) [hereinafter Coffee, *Reforming*] (arguing that Rule 10b-5 actions fail to adequately deter individual managers). Critics have argued that firms should have more flexibility in choosing the degree of disclosure they give to investors. See, e.g., Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 907 (1998) (recommending a regulatory regime that “focuses on regulatory competition and gives issuers and investors the ability to choose the law that governs their transactions”); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2427 (1998) (suggesting that firms should be permitted to select their own securities regulators).

10b-5 is thus seen primarily as a rule that protects the efficiency of markets.

B. Doctrinal Limits

Consistent with the view that Rule 10b-5 primarily encourages efficient markets, courts for a time mostly interpreted Rule 10b-5 as a narrow antifraud rule. This is not surprising, as the text of all three subsections of Rule 10b-5 focuses on the existence of fraud.⁵⁶ Subsection (a) prohibits any “device, scheme, or artifice to *defraud*.”⁵⁷ Subsection (b) prohibits any “untrue statement of a material fact or . . . [failure] to state a material fact” necessary to make a statement not misleading.⁵⁸ Subsection (c) prohibits “any act, practice, or course of business which operates or would operate as a *fraud or deceit*.”⁵⁹

Although fraud is a notoriously broad concept and includes many types of misconduct,⁶⁰ the Supreme Court has used a narrow conception of securities fraud in the context of Rule 10b-5 that is consistent with the view that the primary purpose of Rule 10b-5 is to promote efficient markets. This conception of Rule 10b-5 as an antifraud rule is defined by at least three essential elements.⁶¹ First, there must be a misrepresentation or omission.⁶² Second, the misrepresentation or omission must be material, that is, significant to the market or investors.⁶³ Third, the material misrepresentation or omission must be “in connection with” a securities transaction.⁶⁴

The requirement of a misrepresentation or omission ensures that Rule 10b-5 is limited to disclosure-related conduct. Not all corporate misconduct qualifies. For example, in *Santa Fe Industries, Inc. v. Green*,⁶⁵ the Supreme Court rejected a Rule 10b-5 claim brought by

56. See 17 C.F.R. § 240.10b-5 (2010).

57. *Id.* § 240.10b-5(a) (emphasis added).

58. *Id.* § 240.10b-5(b).

59. *Id.* § 240.10b-5(c) (emphasis added).

60. See *Carpenter v. United States*, 484 U.S. 19, 27 (1987) (defining fraud broadly as including “the act of embezzlement, which is the ‘fraudulent appropriation to one’s own use of the money or goods entrusted to one’s care by another’” (quoting *Grin v. Shane*, 187 U.S. 181, 189 (1902))).

61. A complete list of the elements that must be alleged by a private plaintiff includes: (1) a material misrepresentation or omission, (2) scienter, (3) reliance, (4) causation, and (5) damages. See, e.g., *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341–42 (2005).

62. *Id.*

63. *Id.*

64. 17 C.F.R. § 240.10b-5.

65. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

minority shareholders who were unhappy with the terms of a proposed merger.⁶⁶ The Second Circuit, in allowing the case to proceed, held that Rule 10b-5 could reach “breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure.”⁶⁷ The Second Circuit found such a breach because the merger did not serve a proper business purpose and was effected without proper notice to the shareholders.⁶⁸ The Supreme Court reversed, finding that a breach of fiduciary duty could not be the basis of a Rule 10b-5 claim without some “deception, misrepresentation, or nondisclosure.”⁶⁹

In two decisions exemplifying this antifraud approach, the Supreme Court focused on the absence of a specific misrepresentation or omission in rejecting aiding and abetting liability for Rule 10b-5 claims. In *Central Bank v. First Interstate Bank*,⁷⁰ the Court reasoned that an aiding and abetting defendant cannot be liable under Rule 10b-5 if it does not make a specific misrepresentation or omission on which the plaintiff relies.⁷¹ In *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.*,⁷² the Court again rejected secondary liability because investors did not directly rely on the secondary actor’s “acts or statements.”⁷³

In addition to the requirement that there be a misrepresentation or omission, the materiality requirement of Rule 10b-5 ensures that the misrepresentation or omission is relevant to the market. Materiality requires that “disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁷⁴ A company might deceive the market or investors with respect to trivial matters, but such conduct is not actionable under Rule 10b-5. It is only when a misrepresentation or omission affects the functioning of a market that the conduct triggers the antifraud rule.

66. *Id.* at 464–65, 475, 479–80.

67. *Id.* at 469–70.

68. *Id.*

69. *Id.* at 476.

70. *Cent. Bank v. First Interstate Bank*, 511 U.S. 164 (1994).

71. *Id.* at 180.

72. *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).

73. *Id.* at 769–70.

74. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)) (internal quotation marks omitted).

Finally, to fall within the scope of Rule 10b-5, the questioned conduct must be “in connection with” the purchase or sale of a security.⁷⁵ Read in conjunction with the requirement that there be a misrepresentation that is material, the “in connection” requirement helps ensure that Rule 10b-5 does not cover conduct without a nexus to investors or the markets. Rather than regulating all misconduct that happens to relate to the securities industry, an antifraud reading of the “in connection” requirement directs Rule 10b-5 at conduct that hinders the ability of markets to price securities.⁷⁶

II. RULE 10B-5, INSIDER TRADING, AND THE UNJUST ENRICHMENT PRINCIPLE

Despite the theoretical and doctrinal power of the portrayal of Rule 10b-5 as an antifraud rule that promotes efficient markets, there is one area of Rule 10b-5 jurisprudence that is difficult to reconcile with that narrative. As discussed in this Part, the prohibition of insider trading by Rule 10b-5 fits uneasily with the view that Rule 10b-5 is directed primarily at fraud. Although the classical theory of insider trading tried to conceptualize insider trading as a fraudulent failure to disclose by insiders, the Supreme Court’s adoption of the misappropriation theory in *O’Hagan* makes it clear that insider trading doctrine reflects an unjust enrichment principle. This Part describes how Rule 10b-5 evolved from a narrow focus on fraud to a broader focus on unjust enrichment through the development of insider trading doctrine.

A. *The Classical Theory of Insider Trading*

The quintessential example of insider trading involves an individual who has obtained important information about a company that is not available to the public. When that information becomes publicly known, the company’s stock price will move significantly higher (or lower). The individual can profit from such information by purchasing (or selling) the stock before the information is released. Rule 10b-5 has been the primary basis for prohibiting insider trading.⁷⁷ As this Section shows, this prohibition has been criticized on

75. 17 C.F.R. § 240.10b-5 (2010).

76. For an early discussion of how courts interpreted the “in connection” requirement, see generally Barbara Black, *The Second Circuit’s Approach to the “In Connection With” Requirement of Rule 10b-5*, 53 BROOK. L. REV. 539 (1988).

77. See, e.g., 17 C.F.R. § 240.14e-3 (prohibiting insider trading relating to tender offers).

two grounds: (1) insider trading does not harm investors and may even make markets more accurate, and (2) insider trading doctrine is not a fraud that fits within the scope of Rule 10b-5.

1. *The Efficient-Markets Critique of the Insider Trading Prohibition.* As discussed earlier, Henry Manne criticizes the insider trading prohibition on the ground that insider trading facilitates the transfer of information to efficient markets.⁷⁸ Unlike the typical securities fraud case, in which a company misleads investors about its condition, causing them to purchase stock at inflated prices, it is difficult to trace just whom insider trading directly harms.⁷⁹ And if insider trading makes markets operate more efficiently, the benefits of allowing insider trading might outweigh the harm.

78. See *supra* Part I.A; see also Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 868 (1983) (reasoning that communicating information through insider trading gives firms power to control information contained in the share price). However, there is little empirical support for the market-efficiency argument. See Stephen Bainbridge, *The Insider Trading Prohibition: A Legal and Economic Enigma*, 38 U. FLA. L. REV. 35, 63–65 (1986) (noting the ambiguity of the evidence supporting the market-efficiency justification for insider trading); James D. Cox, *Insider Trading and Contracting: A Critical Response to the “Chicago School.”* 1986 DUKE L.J. 628, 648 (“Manne’s thesis has no reliable support in either theory or empirical data.” (footnote omitted)).

Manne also argues that insider trading might be a way of compensating managers. See MANNE, *supra* note 32, at 111–58. A problem with such an arrangement might be that an executive compensated in this way would have an incentive to increase the volatility of the stock to exploit his access to inside information. See, e.g., Cox, *supra*, at 636–37 (discussing possible ways in which insiders might manipulate disclosures or corporate activities to benefit themselves); Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332 (“The opportunity to gain from insider trading also may induce managers to increase the volatility of the firm’s stock prices.”).

79. See, e.g., Cox, *supra* note 78, at 635 (“[T]he regulation of insider trading cannot be justified out of concern for protecting the unwary investor.”); Dooley, *supra* note 25, at 31 (“It is difficult, however, to draw a convincing, or even plausible, causal connection between the insider trading and the market losses experienced by other investors.”); Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 468 (2001) (“Despite the best efforts of scholars to prove otherwise, it has long been recognized that many investors are unaffected, or even benefited, by insider trading.”).

William Wang has set forth a novel theory of how investors can be harmed by insider trading. See William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217 (1981). According to Wang, “[w]ith a purchase of an existing issue of securities, someone ultimately requires more of that issue; with a sale of an existing issue, someone ultimately acquires more of that issue.” *Id.* at 1235. Wang acknowledges, however, that it is difficult to identify precisely which investors are harmed by insider trading. See *id.* at 1238 (“[T]he Law of Conservation of Securities indicates that although an inside trade does harm specific individuals, identifying them is almost impossible.”).

One response to Manne's argument has been that if insider trading is rampant, investors will not have confidence in the market and will fail to invest.⁸⁰ Victor Brudney argues that the prohibition against insider trading is grounded on remedying unfair informational advantages.⁸¹ An insider who trades based on information that the public cannot access has an unfair advantage because "he has a lawful monopoly on access to the information involved."⁸² To the extent that a trader, whether an insider or outsider, has an "informational advantage that the public is unable lawfully to overcome or offset," it is unfair to allow the trader to exploit such an advantage.⁸³ An insider trading prohibition remedies informational asymmetries, making investors feel comfortable that the markets are not stacked against them.⁸⁴

80. See, e.g., Brudney, *supra* note 23, at 356 (stating that a rational buyer will either refrain from dealing or demand a risk premium if he knows that the party with whom he is conducting business has a material advantage).

81. *Id.* at 338 ("The effort is to deny the possessor an informational advantage in trading with other investors more than to inform the latter about the state of the world in order to facilitate their investment decisions generally.").

82. *Id.* at 346. Professor Saul Levmore also defines fairness with respect to insider trading broadly, arguing that "fairness is achieved when insiders and outsiders are in equal positions." Saul Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 122 (1982).

The asymmetry may even be more unjust because the insider has access to the information solely by reason of his position rather than because he does productive work in uncovering the information. See, e.g., Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13 (1978) (distinguishing between information that is deliberately found and information that is casually discovered).

83. Brudney, *supra* note 23, at 360. Of course, Brudney would not prohibit traders from exploiting lawful asymmetries of information. See *id.* at 361-63.

84. See *id.* at 357 ("[I]n its effort to restore faith in the securities market, Congress concluded that [insider] informational advantages should be denied."). The Supreme Court in *O'Hagan* relied in part on Brudney's conception of fairness in justifying the prohibition against insider trading. See *United States v. O'Hagan*, 521 U.S. 642, 659 (1997) (citing Brudney, *supra* note 23, at 356).

The notion that insider trading is unfair is widespread. See, e.g., Dooley, *supra* note 25, at 43 ("Every argument in favor of regulating insider trading proceeds from the crucial assertion that it is such a deviation from generally accepted standards of conduct that it is morally wrong."). As the SEC noted in *Matter of Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907 (Nov. 8, 1961), the prohibition against such trading is based in part on "the inherent unfairness involved where a party takes advantage of [inside] information knowing it is unavailable to those with whom he is dealing." *Id.* at 912. Justice Blackmun in particular subscribed to a fairness theory of insider trading. See *Chiarella v. United States*, 445 U.S. 222, 248 (1980) (Blackmun, J., dissenting) (arguing in his dissent that insider trading is "inherently unfair"); see also Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 233 (1991) ("The successful inside trader has won the lottery without buying a ticket.").

A problem with the investor-confidence theory is that it is almost impossible to test empirically.⁸⁵ Whereas the market impact of fraudulent information is commonly measurable by examining stock price movements after the fraud is admitted, there is not a comparable test for measuring the impact of insider trading on investor behavior. Moreover, if insider trading is done discreetly, the public may not perceive that the markets are stacked against them. As a result, it is difficult to link insider trading to a general lack of confidence in the markets. The investor-confidence case for prohibiting insider trading seems more tenuous than the case for prohibiting fraud.

2. *Insider Trading as Fraud?* In addition to the difficulty of justifying a ban on insider trading as necessary for efficient markets, many have questioned how insider trading can be considered a fraud prohibited by Rule 10b-5. It is difficult to say that an individual investor can defraud the market simply by purchasing or selling stock on the open market.⁸⁶ No representation occurs when an investor makes the purchase.⁸⁷ Even if the act of purchasing or selling stock can be read as a signal of what the investor believes the stock is worth, most such purchases are not large enough to significantly affect the market price of a publicly traded stock.⁸⁸

Rather than basing insider trading liability on an affirmative misrepresentation, the classical theory of insider trading bases the prohibition on a fraudulent failure to disclose. Fraud liability for

85. See, e.g., Bainbridge, *supra* note 78, at 63–65 (describing the lack of empirical evidence about the impact of insider trading).

86. See, e.g., Langevoort, *supra* note 10, at 52 (“The open-market insider trading prohibition does not fit comfortably within the fraud and deception framework of section 10(b) and rule 10b-5.”); see also Easterbrook, *supra* note 78, at 318 (“A considerable distortion of language underlies any holding that trading in a market without issuing a press release is ‘fraud’ or ‘deceit.’”). But see Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O’Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1225 (1998) (arguing that investors are defrauded by insider trading).

87. See, e.g., Dooley, *supra* note 25, at 59 (“[I]nsider trading in no way resembles deceit. No representation is made, nor is there reliance, change of position, or causal connection between the defendant’s act and the plaintiff’s losses.”).

88. Of course, this assumes that the market does not infer the existence of inside information from the trades. See, e.g., Cox, *supra* note 78, at 635 (“The investor’s decision to sell or purchase is unaffected by whether the insider is also secretly buying or selling shares in the open market.”); Easterbrook, *supra* note 78, at 336 (“The insider’s trading thus may lead to price adjustments, but only to the extent the insider’s secret has leaked to the market or been inferred by traders.”).

nondisclosure can only attach when there is a duty to make a disclosure.⁸⁹ Such a duty to disclose exists for directors and officers of a corporation who have a fiduciary duty of loyalty to their shareholders. As fiduciaries of the shareholders, directors and officers cannot profit at the expense of shareholders without disclosure.⁹⁰ Insider trading enriches directors at the expense of the shareholders with whom they trade. Rule 10b-5 has thus been read to subject insiders to what has been called the “disclose-or-abstain” rule.⁹¹ That is, an insider must either disclose any insider information or abstain from trading.⁹²

Thus, for a time, the courts linked securities fraud and fiduciary duty in the context of insider trading liability. Despite providing a convincing rationale for the prohibition, the incorporation of fiduciary duty concepts is in tension with the idea that Rule 10b-5 is primarily an antifraud rule. As the Supreme Court held in *Santa Fe*

89. As the Supreme Court has observed, “one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so.” *Chiarella*, 445 U.S. at 228.

90. Of course, the duty arguably does not extend to future shareholders, though it would be arbitrary to protect present shareholders while not protecting future shareholders. *See, e.g., id.* at 227 n.8 (noting that merely selling stock to an individual may create a fiduciary relation to the buyer).

91. The SEC was the first to recognize such a rule with respect to insiders. *See In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907, 911 (Nov. 8, 1961) (“We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.”). The courts soon followed. *See, e.g., Chiarella*, 445 U.S. at 230 (“[J]udicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10 (b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure.”); *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848–49 (2d Cir. 1968) (en banc) (“[A]nyone in possession of material inside information must either disclose it . . . or . . . must abstain from trading in or recommending the securities . . .”).

In addition, lawyers, accountants, and consultants to the company can be considered “constructive insiders” who are also subject to the disclose-or-abstain rule. *See Dirks v. SEC*, 465 U.S. 646, 655 n.14 (1983) (“The basis for recognizing [an outsider’s] fiduciary duty is . . . that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes.”).

92. *See, e.g., United States v. O’Hagan*, 521 U.S. 642, 651–52 (1997) (noting that under the classical theory of insider trading, Rule 10b-5 confers a duty to disclose inside information or abstain from trading); *In re Refco Capital Mkts., Ltd. Brokerage Customer Sec. Litig.*, No. 06 Civ. 643, 2007 WL 2694469, at *7 (S.D.N.Y. Sept. 13, 2007) (“Another kind of securities fraud claim is based on conduct that is deceptive because it is inconsistent with a fiduciary duty. In claims of this kind, the fiduciary duty serves as a sort of standing false representation by the fraudster, who deceives the victim by violating the commitment associated with her fiduciary duty.”).

Industries, Inc. v. Green, a breach of a fiduciary duty by itself does not give rise to a cause of action under Rule 10b-5.⁹³ Profiting at the expense of shareholders, although it violates fiduciary duties, does not necessarily affirmatively defraud those shareholders.⁹⁴ On the other hand, covert trading on secret information by insiders can be characterized as deceptive, so it might be differentiated from the nondeceptive breach of fiduciary duty in *Santa Fe Industries*.

Though insider trading involves an omission, such an omission is not material in the same sense in which a fraudulent statement or omission in the company's financial statements can be material. Although inside information is material in that if it were revealed, the stock price would be altered, the act of trading on that information before it is revealed does not necessarily affect the stock price if the trading is discreet and modest in amount. Any deception by the insider relates to his particular duties to shareholders of the company rather than any broader duty to the market. Thus, it is difficult to argue that insider trading is like a fraud on the market.

Even if the failure to disclose harms the market, one commentator notes that under current case law, an insider could theoretically remedy that deficiency by disclosing to the market that he will trade on inside information.⁹⁵ Although it is unlikely that such candid insider trading would be implemented in practice, the argument demonstrates that fraud does not provide a complete explanation for why insider trading is wrong. If an insider can remedy the harm of nondisclosure by making a simple disclosure of the intent to trade on inside information, the prohibition seems trivial.⁹⁶ Though the courts and the SEC claim to be simply applying the antifraud rule in promulgating a disclose-or-abstain rule, the reality is that the prohibition is at least partly motivated by other considerations.⁹⁷

93. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 476 (1977) (“[T]he cases do not support the proposition . . . that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule.”).

94. See, e.g., Fisch, *supra* note 84, at 192–94 (noting that a breach of fiduciary duty to shareholders is not necessarily deceptive).

95. See Prakash, *supra* note 10, at 1507 (“A careful examination of several cases and examples . . . help[s] prove the admittedly counterintuitive claim that Candid Insider Trading does not run afoul of Rule 10b-5.”).

96. See *id.* at 1516–17 (arguing that even a “modest disclosure” or “a one-time, blanket statement of intent to trade” might avoid the prohibition of deception).

97. See, e.g., WANG & STEINBERG, *supra* note 10, § 3:5.2 (“The public perception is that much stock market insider trading unjustly enriches the information possessor. This enrichment results from the trade rather than from the nondisclosure.”).

In addition, the classical theory allows for a substantial amount of trading on nonpublic information. If an individual is not a fiduciary, there is no fiduciary duty to disclose. In *Chiarella v. United States*, the Supreme Court reviewed the criminal conviction of a noninsider, Chiarella, who worked for a company that printed announcements of corporate takeover bids.⁹⁸ Chiarella used information from the documents to trade in the companies that would be subject to such bids.⁹⁹ Initially, Chiarella was convicted on a theory of fraudulent nondisclosure set forth in a jury charge that “permitted the jury to convict the petitioner if it found that he willfully failed to inform sellers of target company securities that he knew of a forthcoming takeover bid that would make their shares more valuable.”¹⁰⁰ The Court overturned the conviction because Chiarella was not an officer or director of any of the companies whose stock he traded and thus had no duty of disclosure to the shareholders of those companies.¹⁰¹

3. *Unjust Enrichment as a Basis for the Insider Trading Prohibition.* Despite its focus on fiduciary duty, *Chiarella* also laid the foundation for an unjust enrichment rationale for prohibiting insider trading. In his *Chiarella* dissent, Chief Justice Warren Burger argued that Chiarella’s conduct should trigger liability because it “quite clearly serves no useful function except his own enrichment at the expense of others.”¹⁰² Burger thus urged the Court to adopt a misappropriation theory that would cover noninsiders.¹⁰³ Soon after

98. *Chiarella v. United States*, 445 U.S. 222, 224 (1980).

99. *Id.*

100. *Id.* at 226.

101. *Id.* at 231 (“Petitioner’s use of that information was not a fraud under § 10 (b) unless he was subject to an affirmative duty to disclose it before trading.”).

102. *Id.* at 241 (Burger, C.J., dissenting); see also Langevoort, *supra* note 10, at 2 (“Persons in a position to have special access to confidential information bearing on the value of a security are perceived as being unjustly enriched when they trade with others who are unable to discover that information.”).

103. In a later case, *Dirks v. SEC*, 463 U.S. 646 (1983), the Court used unjust enrichment language in determining when someone can be liable for receiving inside information from an insider. Such a receiver of information, or tippee, can only be liable for insider trading if the tipper breached a fiduciary duty to shareholders and the tippee knew or should have known of the breach. *Id.* at 660. To determine whether there is a fiduciary breach by the insider who passes on information, “the test is whether the insider personally will benefit, directly or indirectly, from his disclosure.” *Id.* at 662. Thus, *Dirks* centers liability for disclosing insider information on a personal benefit gained by an insider—unjust enrichment. See, e.g., *United States v. O’Hagan*, 521 U.S. 642, 663 (1997) (noting that there was no liability in *Dirks* because

the Court's decision in *Chiarella*, a number of commentators argued that the insider trading prohibition could be rooted in an unjust enrichment principle.¹⁰⁴

A few years after *Chiarella*, Robert Thompson focused on the concept of restitution in making an unjust enrichment case against insider trading.¹⁰⁵ Thompson explains that the scope of Rule 10b-5 can be better understood by distinguishing between “tort principles measuring harm to the plaintiff and unjust enrichment principles measuring gain to the defendant.”¹⁰⁶ Thompson cites a notable First Circuit decision from 1965, *Janigan v. Taylor*,¹⁰⁷ which couched its decision in a securities fraud case in unjust enrichment language, stating: “it is simple equity that a wrongdoer should disgorge his fraudulent enrichment.”¹⁰⁸ Thompson noted that the prohibition of insider trading is better explained as an example of restitution rather than compensation.¹⁰⁹ For insider trading cases, “the guiding principle

“[t]he insiders had acted not for personal profit, but to expose a massive fraud within the corporation”).

104. See, e.g., Langevoort, *supra* note 10, at 26 (“After all, the primary justification for the abstain-or-disclose rule in open-market trading is avoidance of unjust enrichment . . .”); Thompson, *supra* note 10, at 396 (“[T]he prohibition [against insider trading] is aimed at preventing insiders’ unjust enrichment.”).

105. See Thompson, *supra* note 10, at 397–98 (“Unjust enrichment as a separate theory of recovery . . . provides a better foundation to consider the more difficult problems raised in open-market insider trading cases.”).

106. *Id.* at 356. Restitution has long been recognized as a legitimate remedy for securities fraud. In its 1972 decision *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Supreme Court recognized that a plaintiff bringing a securities fraud action could argue for damages based on either the plaintiff's loss or the defendant's gain from the fraud. *Id.* at 154–55. If “the defendant received more than the seller's actual loss,” the “damages are the amount of the defendant's profit.” *Id.* at 155; see also *Randall v. Loftsgaarden*, 478 U.S. 647, 661–62 (1986) (recognizing a restitution remedy for Rule 10b-5 cases); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 634 (1985) (“‘Injury’ and ‘restitution’ are the competing paradigms of damages in securities law.”).

Restitution has often been linked to unjust enrichment. See, e.g., *SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978) (noting in a Rule 10b-5 case that “restitution merely forces the defendant to give up to the trustee the amount by which he was unjustly enriched”); *SEC v. Commonwealth Chem. Sec., Inc.* 574 F.2d 90, 95 (2d Cir. 1978) (“Disgorgement of profits in an action brought by the SEC to enjoin violations of the securities laws appears to [be an equitable remedy]; the court is not awarding damages to which plaintiff is legally entitled but is exercising the chancellor's discretion to prevent unjust enrichment.”); Peter B. Oh, *Tracing*, 80 TUL. L. REV. 849, 880 (2006) (noting that restitution can be a way of remedying unjust enrichment).

107. *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965).

108. *Id.* at 786.

109. See Thompson, *supra* note 10, at 391–97 (arguing for the superiority of the restitution explanation in explaining the insider trading prohibition). Donald Langevoort has revived the possibility of using restitution as a means of securities fraud enforcement. Donald C.

is to make the defendant give back that which he obtained by invasion of the plaintiff's interest whether or not that gain equals the plaintiff's loss."¹¹⁰

Donald Langevoort, in analyzing the *Chiarella* decision, makes an unjust enrichment case against insider trading rooted in what he calls the fiduciary principle.¹¹¹ Because insiders owe fiduciary duties of loyalty and disclosure to shareholders, Langevoort observes that "[r]equiring public disclosure by the insider in the open-market situation furthers a significant objective underlying the fiduciary disclosure rule—that of preventing unjust enrichment."¹¹² In analyzing whether insider trading outside of the insider context should be prohibited, Langevoort argues that "[a]s a matter of preventing unjust enrichment, . . . a duty to disclose is clearly called for when the information advantage derives from unlawful acquisition or use of the information."¹¹³

Chief Justice Burger and Professors Thompson and Langevoort all expressed the common-sense intuition that insider trading involves unjust enrichment.¹¹⁴ The problem, though, was reconciling an unjust enrichment view with doctrine that more and more viewed Rule

Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627, 630 (2007) ("[M]y attention in this Article is on equitable remedies—especially rescission and restitution—as underutilized tools in securities fraud enforcement.").

Easterbrook and Fischel argue for an application of restitution that would limit Rule 10b-5's impact. They claim that restitution, rather than compensation measured by the market decline suffered by shareholders, is the optimal damages measure for securities fraud. In open-market securities fraud cases, for every person who loses by buying stock inflated by fraud there is a person who gains by selling stock inflated by fraud, so the gains and losses from securities fraud cancel each other out. Thus, damages that measure the net harm to investors may not be meaningful. Instead, the optimal damages may be some measure of the profits captured by the person perpetrating the fraud—in other words, restitution. Easterbrook & Fischel, *supra* note 106, at 634, 641–42.

110. Thompson, *supra* note 10, at 393.

111. Langevoort, *supra* note 10, at 19.

112. *Id.*; see also Gareth Jones, *Unjust Enrichment and the Fiduciary's Duty of Loyalty*, 84 LAW Q. REV. 472, 476 (1968) ("[I]t is all too evident that the dishonest fiduciary has been unjustly enriched. . . . [H]e has received a *benefit* (his profit), . . . gained it *at his principal's expense* (by exploiting his position of trust), and . . . it would be *unjust* to allow him to retain that benefit.").

113. Langevoort, *supra* note 10, at 52.

114. The intuition that insider trading is immoral is longstanding. See MANNE, *supra* note 32, at 3 ("The absence of any accepted economic tools for analyzing this subject made the insider-trading area a fertile one for the lawyers' equity approach with its overtones of fairness and morality.").

10b-5 as an antifraud rule. Despite its intuitive appeal, the argument that an unjust enrichment principle explained the insider trading prohibition had an uncertain status for almost twenty years.

B. The Misappropriation Theory of Insider Trading: Triumph of the Unjust Enrichment Principle

Chiarella's adoption of the classical theory of insider trading would leave a significant amount of insider trading unregulated. If insider trading is viewed solely as a fraud, it might only cover insiders with special fiduciary duties, leaving uncovered those who profit from misappropriated information but have no fiduciary relationship to the company's shareholders. As this Section describes, in *United States v. O'Hagan*, the Supreme Court extended the prohibition beyond fiduciary relationships to cover misappropriators lacking a fiduciary duty to the traded company's shareholders, moving the Rule 10b-5 prohibition against insider trading further from the antifraud rule and closer to the unjust enrichment principle.

1. *United States v. O'Hagan*. *O'Hagan* was a case involving an inside trader who did not owe a fiduciary duty to the shareholders of the corporation whose stock he traded. *O'Hagan* was an attorney for a firm that represented an acquirer of another company.¹¹⁵ Although *O'Hagan* and his firm owed a duty to the acquirer, *O'Hagan* owed no fiduciary duty to the target company, and he traded on inside information relating to the target.¹¹⁶ In affirming the conviction of *O'Hagan* for insider trading, the Supreme Court adopted what it called the misappropriation theory,¹¹⁷ which was "designed to 'protect[t] the integrity of the securities markets against abuses by outsiders.'"¹¹⁸

Under the misappropriation theory, a noninsider is liable for insider trading if he misappropriates information from a source to which he owes some duty of confidentiality. Rather than "premissing

115. *United States v. O'Hagan*, 521 U.S. 642, 647 (1997).

116. *See id.* (describing *O'Hagan*'s role at his law firm and illustrating that he had no role in the negotiations or with the target company).

117. *Id.* at 653–54 ("We agree with the Government that misappropriation . . . satisfies § 10(b)'s requirement that chargeable conduct involve a 'deceptive device or contrivance' used 'in connection with' the purchase or sale of securities.").

118. *Id.* at 653 (alteration in original) (quoting Brief for the United States at 14, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), 1997 WL 86306) (internal quotation marks omitted).

liability on a fiduciary relationship between 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."¹¹⁹ O'Hagan violated this rule because he deceived the source of the information, his law firm, to which he owed a duty of confidentiality.¹²⁰

O'Hagan is unclear with respect to the source and scope of this duty of nondeception. Indeed, the Court was unclear about what to call the duty, introducing the term "agency" as an additional descriptor of the type of relationship that could trigger insider trading obligations.¹²¹ For example, the Court cited to the *Restatement (Second) of Agency* relating to an "agent's disclosure obligation regarding use of confidential information."¹²² Though O'Hagan was a partner with fiduciary duties to his other partners,¹²³ and the Court at times uses the language of fiduciary duty,¹²⁴ the Court also stated that liability would be appropriate for a mere employee of the *Wall Street Journal*.¹²⁵ Thus, the misappropriation theory appears to range wider than fiduciary relationships to shareholders, extending to any principal-agent relationship in which information is conveyed with an expectation of confidentiality.¹²⁶

2. *Misappropriation as a Departure from the Antifraud Conception of Rule 10b-5.* By broadening Rule 10b-5 to encompass

119. *Id.* at 652.

120. *See id.* at 653 (approving the government's misappropriation theory set forth in the indictment, which alleged "that O'Hagan, in breach of a duty of trust and confidence he owed to his law firm, Dorsey & Whitney, and to its client, Grand Met, traded on the basis of nonpublic information").

121. *See, e.g., id.* at 661 (referring to a lack of "agency or other fiduciary relationship").

122. *Id.* at 654–55 (citing RESTATEMENT (SECOND) OF AGENCY §§ 390, 395 (1958)).

123. *Id.* at 647, 653 (noting that O'Hagan was a partner at Dorsey & Whitney and owed the firm a "duty of trust and confidence").

124. *Id.* at 647, 652, 655 (discussing § 10(b) violations as "breach[es] of a fiduciary duty," "breach[es] of a duty of loyalty and confidentiality," and "breach[es] of a duty of loyalty").

125. *See id.* at 654 (citing with approval the imposition of liability for misappropriation in *Carpenter v. United States*, 484 U.S. 19 (1987)).

126. *See* A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 15 (1998) ("The Court's decision in *O'Hagan* breaks new ground in establishing a foundation for insider trading based on common law agency principles, thereby departing from Powell's vision of the scope of insider trading prohibited by §10(b)."); *see also* Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1340–46 (2009) (documenting the trend of courts finding insider trading in the absence of fiduciary duty post-*O'Hagan*).

agency relationships other than the fiduciary relationship between insiders and shareholders, the misappropriation theory runs further from an antifraud and efficient-markets conception of Rule 10b-5.¹²⁷ Although the classical theory could purport to ground the prohibition in a duty to disclose owed to shareholders, the duty at stake in *O'Hagan* was a duty to a law firm. A law firm is not a direct market participant and certainly cannot be said to be the market. In contrast to the typical fraud-on-the-market case, in which there is a direct link between a deception and the market, a misappropriation insider-trading case involves conduct that has at best a tenuous link to the market.

Though the Court attempted to frame the misappropriation theory as fraud by noting that “[d]eception through nondisclosure is central to the theory of liability,”¹²⁸ the deception by a misappropriator is of a different kind than a typical fraudulent nondisclosure relating to a security that harms investors. As many commentators have noted, the deception in a misappropriation case is directed at the source of the information rather than at the market.¹²⁹ The *O'Hagan* Court read the requirement that a deception be “in connection with” a securities transaction broadly, noting that the phrase does not require “deception of an identifiable purchaser or seller.”¹³⁰ Rather than requiring the deception to be directed at the

127. The Supreme Court acknowledged that disclosure would eliminate any element of fraud with respect to a misappropriation. Under *O'Hagan*, “full disclosure forecloses liability under the misappropriation theory,” *O'Hagan*, 521 U.S. at 655, implying that candid insider trading is permissible. Indeed, the Court states that an agent could avoid Rule 10b-5 liability by disclosing his intent to trade on insider information to the principal. *Id.*; see also Prakash, *supra* note 10, at 1510–16 (observing that *O'Hagan* appears to allow for candid insider trading).

128. *O'Hagan*, 521 U.S. at 654.

129. See, e.g., Richard W. Painter, Kimberley D. Krawiec & Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 190 (1998) (noting that misappropriation theory “turns not on effects on the marketplace or on potential damage to selling or purchasing shareholders, but rather on a duty owed to the source of the information, regardless of whether that source is a buyer or seller of securities”); Prakash, *supra* note 10, at 1533 (noting that after *O'Hagan* “Rule 10b-5 now regulates deceptions of parties unconnected to the securities markets”); Pritchard, *supra* note 126, at 44 (“[T]here is no principled way to limit the misappropriation theory to market participants.”).

130. *O'Hagan*, 521 U.S. at 658. This language is consistent with an earlier case in which the Court made it clear that Section 10(b) “is not limited to preserving the integrity of the securities markets.” *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971) (internal quotation marks omitted).

market or investors, *O'Hagan* only requires that the deception “coincide” with a particular securities transaction.¹³¹

The Supreme Court in *O'Hagan* also rejected a narrow reading of its decision in *Central Bank*, which the lower appeals court had read as imposing a requirement that a Rule 10b-5 claim be based on a specific misrepresentation or omission relied upon by investors.¹³² The Court found that there was no such requirement and that its rejection of aiding and abetting liability in *Central Bank* was based primarily on “policy considerations.”¹³³ In clarifying that Rule 10b-5 does not require a specific misrepresentation or omission, the Court rejected a strict antifraud conception of Rule 10b-5 and set the foundation for unjust enrichment claims based on a broader range of deceptive conduct.

In addition to an agency theory, *O'Hagan* also seems to base the insider trading prohibition on a property-rights theory.¹³⁴ The

131. See *O'Hagan*, 521 U.S. at 656 (“The securities transaction and the breach of duty thus coincide.”).

132. *Id.* at 664 (“The Eighth Circuit isolated the [Court’s] statement . . . and drew from it the conclusion that § 10(b) covers only deceptive statements or omissions on which purchasers and sellers, and perhaps other market participants, rely. It is evident . . . , however, that this Court . . . sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct.” (citation omitted)); see also *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 769 (2008) (“If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous.”).

133. *O'Hagan*, 521 U.S. at 664–65 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975)).

134. The idea that insider trading may violate the property rights of the corporation dates back to at least the 1920s. See, e.g., A.A. Berle, Jr., *Publicity of Accounts and Directors' Purchases of Stock*, 25 MICH. L. REV. 827, 828 (1927) (noting the theory that “the detailed information of a director was the property of the corporation, and could not be used for his own benefit”). Modern scholars have often made this argument as well. See, e.g., Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1252–57 (1995) (arguing that federal insider-trading law protects the exclusive rights of a corporation to nonpublic information); Carlton & Fischel, *supra* note 78, at 865–66 (relying on “[t]he notion that the dispute concerning insider trading is really a dispute about which party more highly values a property right”); Krawiec, *supra* note 79, at 449 (“The recognition that many of the fundamental issues in securities regulation essentially reduce to a matter of allocating property rights in valuable information is one of the greatest contributions of law and economics scholars to the securities law literature in recent years.”); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 11 (1984) (“[P]rivileged corporate information is a valuable asset in the nature of a property interest.”); Richard J. Morgan, *Insider Trading and the Infringement of Property Rights*, 48 OHIO ST. L.J. 79, 80 (1987) (describing “inside information

O'Hagan Court observed that “[a] company’s confidential information . . . qualifies as property to which the company has a right of exclusive use.”¹³⁵ A property-rights theory would be a clear break from an antifraud approach to Rule 10b-5. The property-rights theory does not hinge upon whether someone has been misled, but instead implies that any unauthorized use of property would trigger liability.¹³⁶ Though the misappropriation of property can also be fraudulent (an individual can take property through a misrepresentation), such misappropriation does not have to involve an affirmative misrepresentation or omission: the property is simply taken.

If inside information is viewed as a theft of corporate property, the scope of the insider trading prohibition might be both expanded and narrowed. It would be expanded because the prohibition would not be conditioned on the existence of a fiduciary or agency relationship.¹³⁷ On the other hand, if inside information is the property of the corporation, nothing prevents corporations from contracting with insiders to allow them to trade on nonpublic information, thus narrowing the reach of the insider trading prohibition.¹³⁸ But given the unlikelihood that insider trading would

as property that can be owned and used by or for the benefit of the owner or creator of that property”).

135. *O'Hagan*, 521 U.S. at 654 (citing *Carpenter v. United States*, 484 U.S. 19, 25–27 (1987)). The SEC opinion introducing the federal prohibition of insider trading, *In re Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 SEC Docket 907 (Nov. 8, 1961), can be understood in part as advancing a “business property” theory. The prohibition arises in part from “the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone.” *Id.* at 912; see also Easterbrook, *supra* note 78, at 321 (noting that *Cady, Roberts & Co.* is rooted partly in the “business property” theory).

136. See, e.g., Morgan, *supra* note 134, at 101 (“All that the plaintiff must establish is that he or she owned (or had rights in) the information, that those ownership or other rights were infringed by the defendant, and that the plaintiff suffered damage.”).

137. See, e.g., Nagy, *supra* note 126, at 1340–44 (describing cases in which misappropriation theory has been extended to thefts of inside information by individuals without connection to the corporation).

138. For some critics, the possibility of authorizing insider trading by contracting is a problem of the property-rights theory. See, e.g., Fisch, *supra* note 84, at 225–26 (“[V]iewing inside information as property justifies treating the misappropriation of that property as theft but correspondingly requires the government to defer to firm decisions contractually allocating the entitlement to that property.”). For proponents of the theory, the property-rights theory is attractive for the very same reason. See, e.g., Carlton & Fischel, *supra* note 78, at 866–72 (describing reasons why corporations might want to contract with managers to allow insider trading); David D. Haddock & Jonathan R. Macey, *A Coasian Model of Insider Trading*, 80 NW. U. L. REV. 1449, 1467–68 (1987) (arguing that corporations should be permitted to opt out of

be widely authorized,¹³⁹ on balance, a property-rights theory would prohibit a broader range of conduct than the classical theory.

C. *Elements of the Unjust Enrichment Principle*

By regulating deceptions that run afoul of agency duties or infringe on the property rights of the corporation, the Supreme Court has created a second broad category of concern for Rule 10b-5: cases of unjust enrichment. The fiduciary-duty, agency, and property-rights theories all have elements that allude to the unjust enrichment principle. As Langevoort notes in commenting on *Chiarella*, when a fiduciary trades on inside information, his failure to disclose is unjust enrichment.¹⁴⁰ Similarly, an agency theory might couch the wrong more broadly as an agent profiting from access to information at the expense of the principal.¹⁴¹ The property-rights theory formulates the wrong as enriching oneself by misappropriating information that belongs to the corporation.¹⁴²

At the same time, after *O'Hagan*, the unjust enrichment principle captures the prohibition against insider trading better than any of these three concepts alone. Fiduciary duty does not cover the conduct of outsiders, which *O'Hagan* partly covers through agency law.¹⁴³ Agency theory would not include misappropriations of

insider trading prohibitions to contract with risk-taking managers); Krawiec, *supra* note 79, at 498–99 (proposing that insider trading by outsiders should be regulated primarily by private enforcement of contract law).

139. As a practical matter, it is unlikely that corporations would be willing to permit their managers to trade in a way that hurts their shareholders. *See, e.g.*, Pritchard, *supra* note 126, at 46 (stating reasons why corporations are unlikely to allow insider trading). In addition, allowing parties to contract with respect to insider trading is problematic because it is difficult to assess the costs and benefits of allowing insiders to trade. *E.g.*, Cox, *supra* note 78, at 653–55.

140. Langevoort, *supra* note 10, at 6–27; *see also* Elliot J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 398–400 (1998) (citing common law cases prohibiting insider trading as unjust enrichment by a fiduciary).

141. *See, e.g.*, Fisch, *supra* note 84, at 190 (“[A]gency law suggests that a corporate insider is unjustly enriched by making use of corporate information for his personal benefit and that any trading profits are rightfully the property of the owner of the information—the corporation. This unjust enrichment takes place . . . whether or not the insider discloses the information prior to trading.”).

142. *See, e.g.*, Daniel Friedmann, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 COLUM. L. REV. 504, 509 (1980) (“[R]estitution may be justified on the general principle that a person who obtains—though not necessarily tortiously—a benefit at the expense of another through appropriation of a property or quasi-property interest held by the other person is unjustly enriched and should be liable to the other for any benefit attributable to the appropriation.”).

143. *See* *United States v. O'Hagan*, 521 U.S. 642, 654–55 (1997).

property by nonagents that would be actionable under a property-rights theory.

Although the property-rights theory is broadly inclusive, it does not explain the insider trading prohibition after *O'Hagan* as well as the unjust enrichment principle. There are difficulties with thinking of Rule 10b-5 as a property rights rule. Even if inside information is property, Rule 10b-5 does not regulate all of its uses. The theft of inside information alone would not trigger Rule 10b-5. Such a theft would likely only be covered by state law. The thief must trade on the inside information for profit to trigger Rule 10b-5.¹⁴⁴ In other words, it is the enrichment that matters most, not the taking of the inside information. If Rule 10b-5 were truly a property rights rule, it would also cover the theft of inside information.¹⁴⁵

The idea of insider trading as unjust enrichment has been controversial.¹⁴⁶ Even outside the securities law context, unjust enrichment has a shaky existence because of its vagueness.¹⁴⁷ A number of commentators have highlighted the fact that unjust enrichment has not received the same attention as other more clearly defined torts.¹⁴⁸ It is common to think of unjust enrichment as a substantive basis for liability,¹⁴⁹ but the substance of the principle is

144. See, e.g., *id.* at 656 (“[T]he fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.”).

145. Some might characterize unjust enrichment as simply a fairness argument. Although the unjust enrichment principle is a type of fairness argument, it is a specific type of fairness argument that focuses particularly on personal enrichment.

146. See Strudler & Orts, *supra* note 3, at 375–76 & n.4 (discussing the “struggle[s]” of “[c]ourts and commentators” to form a “coherent answer” for why insider trading is wrong); see also *id.* at 404–08 (discussing the merits of using unjust enrichment to explain why insider trading is wrong).

147. See, e.g., Friedmann, *supra* note 142, at 504 (“[Unjust enrichment] has on occasion been regarded as too indefinite and vague to be recognized as a general legal principle, with concern expressed that its adoption might undermine legal stability, confuse legal thinking, and jeopardize clear, systematic organization of the law.” (footnote omitted)); Emily Sherwin, *Restitution and Equity: An Analysis of the Principle of Unjust Enrichment*, 79 TEX. L. REV. 2083, 2106–07 (2001) (“[W]hat makes unjust enrichment both powerful and dangerous when interpreted as a legal principle is its open-endedness.”).

148. See, e.g., Michael Heller & Christopher Serkin, *Revaluing Restitution: From the Talmud to Postsocialism*, 97 MICH. L. REV. 1385, 1385 (1999) (“Whatever happened to the study of restitution?”); Douglas Laycock, *The Scope and Significance of Restitution*, 67 TEX. L. REV. 1277, 1277 (1989) (“Despite its importance, restitution is a relatively neglected and underdeveloped part of the law.”).

149. See, e.g., 1 DAN B. DOBBS, *LAW OF REMEDIES* 552 (2d ed. 1993) (“Unjust enrichment has both a substantive and a remedial aspect.”); Peter Birks, *Unjust Enrichment and Wrongful Enrichment*, 79 TEX. L. REV. 1767, 1779–81 (2001) (arguing that unjust enrichment can support

vague.¹⁵⁰ The *Restatement of Restitution*, which refers to the principle of unjust enrichment, declines to define it, referring to it as a “term of art” and simply stating that “[a] person who has been unjustly enriched at the expense of another is required to make restitution to the other.”¹⁵¹

Regardless of its questionable pedigree in other legal contexts, after *O’Hagan*, the contours of a substantive unjust enrichment principle rooted in Rule 10b-5 have begun to emerge. First, rather than requiring a specific misrepresentation or omission directed at the market or investors, an unjust enrichment principle covers broader forms of deceptive conduct, such as misappropriation, that are not necessarily directed at the market or investors.¹⁵² Second, the unjust enrichment principle is not limited to conduct that directly harms the market but also covers conduct with a more tenuous connection to a securities transaction.¹⁵³ Third, the unjust enrichment principle focuses primarily on benefits wrongfully extracted by the defendant at the expense of others.¹⁵⁴

“a right to restitution”); James J. Edelman, *Unjust Enrichment, Restitution, and Wrongs*, 79 TEX. L. REV. 1869, 1869 (2001) (“[R]estitution’ should be a term that refers only to a particular remedy, and ‘unjust enrichment’ should be a phrase that describes a particular group of actionable causes, none of which is a wrong.”); Friedmann, *supra* note 142, at 510 (“Recognition of this right [to restitution arising from unjust enrichment] is not dependent upon a showing that the appropriation was tortious . . .”); Laycock, *supra* note 148, at 1284 (“Defendant may be unjustly enriched without having committed any other civil wrong.”). *But see* Andrew Kull, *Rationalizing Restitution*, 83 CALIF. L. REV. 1191, 1222–23 (1995) (arguing that restitution should not be viewed as a remedial option, because it can be an independent basis for liability).

150. *See, e.g.*, 1 DOBBS, *supra* note 149, at 557 (noting that the substantive unjust enrichment principle “cannot be precisely defined, and for that very reason has potential for resolving new problems in striking ways”).

151. RESTATEMENT OF RESTITUTION § 1 (1937). The *Restatement* is being revised, but the most recent draft retains this definition of unjust enrichment. *See* RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 (Discussion Draft 2000).

152. This Article uses the words “deceptive” or “deception” to identify a broader form of misconduct that supports an unjust enrichment claim than the typical misrepresentation or omission necessary for an antifraud claim. One way of understanding the admittedly thin distinction between a deception, on the one hand, and a misrepresentation or omission, on the other, is that a deception often involves a course of conduct as opposed to the use of a particular statement to effectuate the fraud.

153. *See* *United States v. O’Hagan*, 521 U.S. 642, 656 (1997) (“The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.”).

154. The obvious remedy for insider trading is the disgorgement of gains or payment of a penalty by the trader. *See* Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 5, 102 Stat. 4677, 4680–81 (codified at 15 U.S.C. § 78t-1 (2006)); Dooley, *supra* note 25, at 14 (“Disgorgement of profits is an increasingly common remedy.”). The remedy

Broken into three simple elements, the unjust enrichment principle applies to (1) deceptive conduct (2) coinciding with a securities transaction (3) that enriches some individual at the expense of others.

III. UNJUST ENRICHMENT AS AN EXPANSIVE PRINCIPLE

In *O'Hagan*, the Supreme Court legitimized the unjust enrichment principle as a substantive basis for liability under Rule 10b-5. This Part describes how, subsequent to *O'Hagan*, the unjust enrichment principle has expanded the reach of Rule 10b-5 in the areas of (1) qualitative materiality, (2) broker-dealer misappropriation, (3) mutual-fund market timing, and (4) stock option backdating. Although other academics have examined aspects of these areas in isolation, this Article is the first to note how they are tied together by the common thread of unjust enrichment.

A. *Qualitative Materiality*

As this Section will show, the unjust enrichment principle has played a substantial role in shaping the requirement that a misstatement be material for it to trigger liability for securities fraud.¹⁵⁵ In particular, the SEC has increasingly relied upon evidence of personal enrichment in determining whether financial misstatements meet the materiality threshold for triggering Rule 10b-5.

As noted earlier, the materiality standard is a key gatekeeper that works by distinguishing important misstatements that affect markets and investor decisions from trivial misstatements that do not. Prior to 1999, misstatements relating to a company's financial statements were arguably subject to a quantitative test—to be material, the misstatement had to exceed 5 percent of net income.¹⁵⁶

reflects the nature of the legal obligation. The insider trading prohibition is concerned with the unjust enrichment by inside traders rather than direct harm to the market.

155. See *Basic Inc. v. Levinson*, 485 U.S. 224, 238 (1988) (“[I]n order to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were misleading as to a material fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.”).

156. See, e.g., COMM. ON CAPITAL Mkts. REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 128 (2006) available at http://www.capmksreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf (“For many years, the rule of thumb was that, in determining the scope of an audit, a potential error exceeding five percent of annual pre-tax income would be considered material. In evaluating a misstatement,

Misstatements below that 5 percent threshold were not material and would not trigger liability for securities fraud.

A quantitative materiality standard is consistent with the view that Rule 10b-5 primarily serves to encourage efficient markets. The rationale for a quantitative standard is that misstatements below the 5 percent threshold are unlikely to substantially affect the market's assessment of a stock. By limiting liability to quantitatively large misstatements, the quantitative standard focuses Rule 10b-5 on misstatements that distort the ability of the market to accurately price securities.

In 1999, the SEC issued Staff Accounting Bulletin No. 99 (SAB No. 99),¹⁵⁷ which instructs that the materiality of financial misstatements should be assessed using a qualitative rather than a quantitative test. Under a qualitative test, a misstatement below the 5 percent quantitative threshold can be material under certain circumstances.¹⁵⁸ For example, a quantitatively small misstatement can be material if it leads to financial results that meet earnings targets or criteria for awarding management bonuses.¹⁵⁹ SAB No. 99 has thus broadened the scope of misstatements that could trigger liability under Rule 10b-5.

One rationale for SAB No. 99 is consistent with an efficient-markets reading of Rule 10b-5. Even small misstatements can mask developments that are significant to the market. A small shortfall in earnings might signal larger shortfalls to come. On the other hand, SAB No. 99 can also be seen as motivated by the unjust enrichment

an error that exceeded ten percent of pre-tax income was considered material, while the materiality of an error between five percent and ten percent of pre-tax income was assessed[] based on various qualitative factors.”); Matthew J. Barrett, *The SEC and Accounting, In Part Through the Eyes of Pacioli*, 80 NOTRE DAME L. REV. 837, 874 (2005) (“As a general rule, accountants and auditors usually treat any amount which does not exceed five percent of income before taxes as immaterial.”); Joseph A. Grundfest & Stephen E. Bochner, *Fixing 404*, 105 MICH. L. REV. 1643, 1662 (2007) (noting the commonality of the 5 percent net-income standard); Glenn F. Miller, *Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality*, 95 NW. U. L. REV. 361, 363 (2000) (“A numerical rule of thumb has emerged: misstatements that impact disclosure by less than five percent are not material.”); Edward A. Weinstein, *Materiality: Whose Business Is It?*, 77 C.P.A. J. 24, 26 (2007) (“Although the professional literature never explicitly defined a ‘normal’ materiality limit, many auditors considered it to be 5% of net income.”).

157. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999).

158. *Id.* at 45,151.

159. *Id.* Other qualitative considerations include whether the misstatement concerns a significant segment of the company's business, affects regulatory compliance, affects the company's ability to comply with loan covenants, or conceals an unlawful transaction. *See id.*

principle. Small misstatements may simply prevent fluctuations caused by the market's overreaction to minor earnings shortfalls that should not significantly affect the long-term valuation of the stock. The motivation for these misstatements might be to allow insiders to sell stock at favorable prices. By targeting this manipulation, SAB No. 99 expresses a concern distinct from that of enabling efficient markets: the concern that certain individuals may be unjustly enriched through securities transactions.

B. Broker-Dealer Misappropriation

The unjust enrichment principle set forth in *O'Hagan* has been the explicit basis for at least one extension of Rule 10b-5 by the Supreme Court. As this Section discusses, the Court cited *O'Hagan* in applying Rule 10b-5 to cover brokers who misappropriate client funds.

In the 2002 case *SEC v. Zandford*,¹⁶⁰ the Supreme Court upheld a Rule 10b-5 claim against a broker who stole funds from a discretionary account he managed for a client.¹⁶¹ Though such theft does not involve a misrepresentation to the market or an investor concerning a particular security,¹⁶² the Court relied upon concepts of fiduciary duty in finding Rule 10b-5 liability. Because the broker failed to disclose the theft to the customer,¹⁶³ he breached a fiduciary duty of loyalty to the customer, thus acting deceptively under Rule 10b-5.¹⁶⁴ Although the deception did not occur with respect to the purchase or sale of a particular security, the funds would have been used to purchase securities, so the Court cited *O'Hagan* in finding

160. *SEC v. Zandford*, 535 U.S. 813 (2002).

161. *Id.* at 815–16.

162. *See, e.g., id.* at 820 (“[N]either the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act.”). Rule 10b-5 has long been understood by courts to prohibit certain deceptive acts by brokers directed at their customers, such as unauthorized trading and churning (excessive trading in an account). *See, e.g., Caiola v. Citibank*, 295 F.3d 312, 323–24 (2d Cir. 2002) (listing cases and situations in which Rule 10b-5 would apply). However, *Zandford* is the first Supreme Court decision that can be linked to the unjust enrichment framework set forth by *O'Hagan*.

163. *Zandford*, 535 U.S. at 823 (“[A]ny distinction between omissions and misrepresentations is illusory in the context of a broker who has a fiduciary duty to her clients.”).

164. *Zandford* must be reconciled with the Court's earlier statement in *Santa Fe* that a breach of fiduciary duty alone cannot sustain a Rule 10b-5 claim. *See supra* note 93. The difference is that there was a deceptive nondisclosure in *Zandford*, whereas there was no allegation of a misrepresentation or nondisclosure in *Santa Fe*.

that the failure to disclose was “in connection with” the purchase or sale of a security because the “securities transactions and breaches of fiduciary duty coincide.”¹⁶⁵

The use of Rule 10b-5 to punish broker-dealer misappropriation is difficult to reconcile with Rule 10b-5 as an antifraud rule that promotes efficient markets. Such theft is wrong, but it is not directed at the market and it does not distort stock market prices. Though framed in terms of a fraud claim involving a nondisclosure, the core harm of *Zandford* is not a failure to disclose. Would the theft have been justified under Rule 10b-5 if the broker had disclosed to the customer that he was misappropriating funds? Even if the nondisclosure enabled the theft, the wrong of the theft is not a lack of disclosure but the taking of the funds by a fiduciary to enrich himself.

Zandford is best understood as an extension of the unjust enrichment principle introduced by *O’Hagan*.¹⁶⁶ Broker-dealer misappropriation involves deceptive conduct (misappropriation) that unjustly enriches an individual (the broker) at the expense of another (the customer). The focus of a broker-dealer misappropriation case is not on damage caused to the market, but on unjust gains captured by the broker. Broker-dealer misappropriation is not a fraud directed at the market but an unjust enrichment much like insider trading.

C. Mutual-Fund Market Timing

The courts have also extended Rule 10b-5 to cover certain types of mutual-fund market timing, in which an investor such as a hedge fund enters into an arrangement with a mutual fund allowing the investor to profit by frequently trading in the mutual fund to take

165. *Zandford*, 535 U.S. at 824–25; see also Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1656–57 (2004) (noting *Zandford*’s expansive interpretation of Rule 10b-5’s “in connection with” requirement).

166. As with the early insider trading cases, *Zandford* has largely been limited to contexts in which there is a fiduciary relationship. See, e.g., SEC v. Dorozhko, 606 F. Supp. 2d 321, 324 (S.D.N.Y. 2008), vacated, 574 F.3d 42 (2d Cir. 2009) (denying the SEC’s motion for a preliminary injunction due to the lack of a fiduciary duty); *In re Refco Capital Mkts., Ltd.*, 586 F. Supp. 2d 172, 194 (S.D.N.Y. 2008) (“[N]one of the complaints adequately alleges that RCM engaged in deceptive conduct through affirmative acts or misrepresentations, breach of a fiduciary duty, or any other manner.”).

There is a question whether the *Zandford* test might be applied to nonfiduciary agency relationships as the Supreme Court did with respect to insider trading in *O’Hagan*, further expanding the reach of the unjust enrichment principle.

advantage of pricing inefficiencies.¹⁶⁷ Market timing often harms other investors in the mutual fund because it generates transaction costs that those investors must bear.¹⁶⁸ Both mutual funds that improperly allow market timing and investors who attempt to profit through market timing have been targeted under Rule 10b-5, with varying degrees of success. This Section describes how both types of market-timing cases implicate the unjust enrichment principle.

At least superficially, mutual funds that allow market timing might be subject to liability under the antifraud interpretation of Rule 10b-5. Because of its costs, many mutual funds have policies against market timing and represent to investors that they prohibit market timing.¹⁶⁹ Funds that publicly proclaim that they prohibit market timing while secretly allowing it are making a material misstatement to their investors. And indeed, many market-timing cases have included standard fraud claims under Rule 10b-5.

In another sense, it is difficult to cabin the harm of allowing market timing solely within the scope of the antifraud rule. The theory that the mutual funds lied about market timing does not capture the full extent of the wrong. If a mutual fund were silent concerning whether it allowed market timing, there would be no fraud cause of action,¹⁷⁰ but there would still be a case that the investor had been wronged under an unjust enrichment theory. Mutual fund managers owe fiduciary duties to mutual fund investors.¹⁷¹ The wrong of market timing is that the mutual fund

167. See, e.g., *SEC v. Gann*, 565 F.3d 932, 934–35 (5th Cir. 2009) (“Market timers typically buy and sell shares of a mutual fund quickly to take advantage of minute, short-term differentials between a fund’s value and the value of the securities it holds.”).

168. See, e.g., *SEC v. Pimco Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 458 (S.D.N.Y. 2004) (“[Market timing] can also harm investors . . . by increasing trading and brokerage costs, as well as tax liabilities, incurred by a fund and spread across all fund investors.”); Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. REV. 1021, 1041 (2007) (citing studies indicating that market timing reduces the returns of nontiming investors).

169. See, e.g., *Pimco Advisors*, 341 F. Supp. 2d at 459 (“The potential for market timing to harm the interests of mutual fund investors has led many mutual funds . . . to adopt policies intended to limit market timing within their funds.”).

170. Indeed, at least one court has dismissed a market-timing case because the funds did not represent to investors that they prohibited market timing and thus the complaint did not sufficiently allege fraud. *SEC v. Tambone*, 417 F. Supp. 2d 127, 134 (D. Mass. 2006) (“[T]he SEC has not alleged that the defendants made any untrue or misleading statement of material fact.”).

171. Investment Company Act of 1940 § 36(a), 15 U.S.C. § 80a-35 (2006); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191–92 (1963) (“The Investment Advisers Act of 1940 thus reflects a congressional recognition ‘of the delicate fiduciary nature of an investment advisory relationship,’ as well as a congressional intent to eliminate, or at least to expose, all

managers deceptively profit at the expense of investors to whom they owe a fiduciary duty. In exchange for the right to time markets, market timers promise mutual fund managers to invest additional assets, increasing the fees earned by the mutual fund managers.¹⁷² And indeed, at least one court has recognized that deceptive market timing can violate Rule 10b-5 under a fiduciary-duty theory.¹⁷³ Allowing market timing is wrong not just because it violates truthful-disclosure obligations, but also because it is a deceptive scheme that enriches a mutual fund's managers at the expense of its investors.

Similarly, parties that have engaged in market timing without the consent of mutual funds that have policies against market timing have also been held liable under Rule 10b-5. Courts have permitted Rule 10b-5 actions against parties who tried to circumvent mutual fund limitations on market timing, often by submitting orders through multiple accounts.¹⁷⁴ The difficulty with fitting such cases under an antifraud theory of Rule 10b-5 is that such conduct does not involve a misrepresentation or omission directed at investors or the market. The market timer is enriched through a deceptive course of conduct relating to its dealings with the mutual fund, which invests on the market timer's behalf. Such deception may not fit within the category of fraud but is captured by the unjust enrichment principle set forth in *O'Hagan*.

conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.” (footnote omitted)); *accord* EBC I, Inc. v. Goldman, Sachs & Co., 832 N.E.2d 26, 31–32 (N.Y. 2005) (recognizing a common-law fiduciary duty).

172. *See, e.g.*, SEC v. Treadway, 430 F. Supp. 2d 293, 298–99 (S.D.N.Y. 2006) (describing a scheme in which a mutual fund gave a hedge fund “market timing privileges in certain PIMCO funds in exchange for long-term or ‘sticky asset’ investments in other PIMCO funds”).

173. *See In re Mut. Funds Inv. Litig.*, 384 F. Supp. 2d 845, 856 (D. Md. 2005) (“Although market timing itself may be lawful, it nevertheless is prohibited by Rule 10b-5 if it is engaged in by favored market insiders at the expense of long-term mutual fund investors from whom it is concealed and who have a right to rely upon its prevention by fund advisers’ and managers’ good faith performance of their fiduciary obligations.”); *see also* Potter v. Janus Inv. Fund, 483 F. Supp. 2d 692, 702 (D. Ill. 2007) (citing favorably the above-quoted language from *Matter of Mutual Funds Investment Litigation*, 384 F. Supp. 2d 845 (D. Md. 2005)). Another court was more skeptical that market-timing arrangements by themselves could support a claim under Rule 10b-5, though it noted that a breach of fiduciary duty might also support a claim under Section 36(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(a) (2006). *Pimco Advisors*, 341 F. Supp. 2d at 469–72.

174. *See, e.g.*, SEC v. Gann, 565 F.3d 932, 936 (5th Cir. 2009) (“The material misstatements at issue are [defendant’s] use of . . . varying client account numbers to disguise the frequency and magnitude of [the defendant’s] trading in the various funds.”); SEC v. O’Meally, No. 06 Civ. 6483, 2008 WL 4090461, at *1 n.1 (S.D.N.Y. Sept. 3, 2008) (describing a Rule 10b-5 claim against brokers who concealed their identities in connection with market-timing transactions).

D. Stock Option Backdating

A final setting in which the unjust enrichment principle has been relevant is the stock option backdating scandal. Again, although stock option backdating has been described as fraud, an equally compelling explanation for the wrongness of the practice is unjust enrichment.

Many companies compensate executives and other workers in part through stock options. A stock option gives an individual the right to buy a stock at a certain price, called the strike price, which is usually equal to the price of the stock on the day the stock option is awarded.¹⁷⁵ In theory, stock options give workers and executives an incentive to increase the value of the firm so that they can exercise their stock options and profit from the differential between the strike price and the increased market price.¹⁷⁶

To make it more likely that recipients would exercise their stock options at a profit, some companies would retroactively change the award date of stock options to an earlier date when the stock price was lower.¹⁷⁷ As a result, the strike price would be lower than if it had been recorded on the day the option was actually granted, increasing the probability that the stock option would be profitable when exercised.¹⁷⁸ When academic studies uncovered this conduct, the revelation resulted in a significant number of criminal and civil enforcement actions.¹⁷⁹

Until 2005, stock option backdating could be used to improperly manipulate the company's financial statements.¹⁸⁰ Prior to that time,

175. See, e.g., Complaint ¶ 13, SEC v. Nicholas, SACV08-539 CJC (C.D. Cal. May 13, 2008); PATRICK CONROY, ERIK STETTLER, NATHAN SAPERIA, SUNIL PANIKKATH & MATTHEW EVANS, OPTIONS BACKDATING: A PRIMER 1–3 (2006), available at http://www.nera.com/extImage/PUB_Backdating_Part_1_Primer_SEC1381_Jul2007-FINAL.pdf.

176. See, e.g., M.P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 MICH. L. REV. 1597, 1605 (2007) (“The inclusion of stock options in executive compensation packages is generally meant to align management’s interests with the interests of the company’s shareholders. This is accomplished by making the executive’s compensation dependent on stock performance.” (footnote omitted)).

177. See, e.g., Erik Lie, *On the Timing of CEO Stock Option Awards*, 51 MGMT. SCI. 802, 805 n.4 (2005) (finding abnormally positive returns after option grants); Charles Forelle & James Bandler, *The Perfect Payday*, WALL ST. J., Mar. 18–19, 2006, at A1.

178. Of course, there is no guarantee that even a backdated stock option will be profitable. See, e.g., David I. Walker, *Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal*, 87 B.U. L. REV. 561, 581–88 (2007).

179. *Id.* at 574–75.

180. In addition, there are tax implications. See, e.g., Narayanan et al., *supra* note 176, at 1621–22 (listing “three potential effects on taxation”).

companies did not have to account for the cost of stock options as an expense unless they were “in the money”—that is, the strike price was lower than the market price on the date that the stock option was awarded.¹⁸¹ Backdating allowed a company to give stock options for which the market price on the date of issue exceeded the strike price, while representing that the options were not “in the money” and not recognizing an expense.

Although stock option backdating might inflate the earnings of a company and be considered a fraud, it is unclear whether the practice fits within the antifraud conception of Rule 10b-5.¹⁸² Backdating arguably involves a misrepresentation; however, backdating by itself may not materially affect the market value of the backdating corporation.¹⁸³ Though backdating affects the way in which the option grant is classified, potentially increasing earnings, in some cases the number of options awarded would not be large enough to significantly distort the market’s assessment of the company’s future earnings.¹⁸⁴ And it is unlikely that stock option backdating was motivated by a desire to inflate earnings by masking the cost of compensation. Companies had wide leeway to give options that were not “in the money” without any earnings impact at all.¹⁸⁵

In backdating cases without a material impact on earnings, one might argue that backdating is important to investors because it says something about the character of management. If that is the case, the antifraud theory at least partly motivates the prohibition against

181. See, e.g., *id.* at 1622 (“If options were granted in-the-money, the difference between the grant date stock price and the exercise price (called the intrinsic value of the option) had to be treated as an expense and deducted from income.”). Since December 2005, companies must expense the fair market value of any stock options. *Id.* at 1623.

182. Many stock option backdating complaints allege violations of Rule 10b-5. See, e.g., *Belova v. Sharp*, No. CV 07-299-MO, 2008 WL 700961, at *7 (D. Or. Mar. 13, 2008) (denying a motion to dismiss a Rule 10b-5 claim in a backdating case); *In re Zoran Corp. Derivative Litig.*, 511 F. Supp. 2d 986, 1013 (N.D. Cal. 2007) (same).

183. See, e.g., Kara Scannell, *Options Fines: A Hard Call*, WALL ST. J., Mar. 8, 2007, at C1 (“[H]ow important was the backdating to Brocade if the stock recovered?”).

184. See, e.g., Narayanan et al., *supra* note 176, at 1611 (“A counterargument to the materiality claim may be made in cases where the backdating or forward-dating produced de minimis income for the executives, and thus had a minor effect on the financial statements.”). Of course, there will be cases in which the extent of backdating will have a significant impact on earnings. See, e.g., *In re Take-Two Interactive Sec. Litig.*, 551 F. Supp. 2d 247, 291–92 (S.D.N.Y. 2008) (finding that backdating was material when it led to overstatement of income by 20 percent in 2002, 11 percent in 2003, and 5–6 percent in 2004 and 2006).

185. Walker, *supra* note 178, at 566 (“Under the accounting rules in place at the time, companies could have issued at-the-money options on unlimited numbers of shares without reporting any compensation expense in their earnings statements.”).

deceptive backdating.¹⁸⁶ But it is equally likely that unjust enrichment rather than fraud is the primary reason such conduct is prohibited and punished.¹⁸⁷ By increasing the probability that they could exercise a stock option at a price below the prevailing market price, executives granted themselves greater amounts of compensation than disclosed.¹⁸⁸ As a result, stock option backdating may have led to the enrichment of executives who manipulated the system, violating the executives' duty of loyalty.¹⁸⁹

Thus, although courts may require plaintiffs to fit backdating claims within an antifraud framework, the reason the backdating scandal spurred outrage was not the practice's impact on earnings statements. The primary wrong of backdating is the gains by those who received backdated stock options rather than direct harm to shareholders.

IV. THE CONVERGENCE OF UNJUST ENRICHMENT AND FRAUD

Though the unjust enrichment strand of Rule 10b-5 doctrine described in Parts II and III is distinct from the rule's antifraud roots, the unjust enrichment and antifraud principles have curiously

186. See, e.g., Langevoort, *supra* note 109, at 644–45 (“The recent options-backdating scandals have been a particularly compelling opportunity to make unjust enrichment arguments.”).

Judge Cote of the Southern District of New York has described a Rule 10b-5 stock option backdating case in unjust enrichment terms:

These defendants received options, the exercise or strike prices of which did not match the actual date on which defendants received them. The options, most of which were allegedly backdated two days, garnered the defendants immediate returns of up to twenty percent of the exercise price. Such benefits are “concrete and personal” because they represent a species of compensation different from the one ordinarily accumulated by corporate officers and directors: In distinction to standard stock options, the returns on the backdated options are immediate and risk-free.

In re Openwave Sys. Sec. Litig., 528 F. Supp. 2d 236, 249–50 (S.D.N.Y. 2007).

187. It is worth noting that many backdating complaints not only allege Rule 10b-5 claims but also state law unjust enrichment claims. See, e.g., *In re Atmel Corp. Derivative Litig.*, No. C 06-4592, 2008 WL 2561957, at *12 (N.D. Cal. June 25, 2008); *In re Verisign, Inc., Derivative Litig.*, 531 F. Supp. 2d 1173, 1217–18 (N.D. Cal. 2007).

188. As David Walker explains, although stock option backdating may not have had a significant earnings effect, the practice made it appear that executives were receiving less compensation through stock options than they really were. By making it appear that executives were receiving options at a time when the stock price was low, stock option backdating may have made it appear that executives received stock options that were worth less than the options that were actually granted. As a result, executives might have been able to negotiate higher pay packages than they would have received without backdating. See Walker, *supra* note 178, at 588–91.

189. See, e.g., Narayanan et al., *supra* note 176, at 1617.

converged. This Part shows how the unjust enrichment principle has been used to subtly shape how Rule 10b-5 targets fraud in the context of the pleading requirements in a securities fraud class action. In many cases, it is becoming more difficult for plaintiffs to avoid dismissal without alleging that some manager was unjustly enriched through the fraud. To the extent that there are doubts about the validity of an unjust enrichment principle, the fact that the principle is invoked by those who seek to narrow the reach of Rule 10b-5 shows consensus on its relevance.

A. *The Scienter Requirement*

The use of the unjust enrichment principle as a limit originates from the requirement that, to state a claim on a Rule 10b-5 securities fraud action, a plaintiff must establish that the defendant acted with scienter. In *Ernst & Ernst v. Hochfelder*,¹⁹⁰ the Supreme Court sensibly read the text of Section 10(b) of the Securities Exchange Act as not extending liability to negligent acts.¹⁹¹ The Court held that to establish securities fraud under Rule 10b-5, a defendant must have acted with some degree of deceptive intent—that is, with scienter.¹⁹²

The need for a scienter requirement is apparent. Imposing liability for accidental misstatements would not make sense from a policy perspective. Companies make thousands of statements in any given year; some will contain mistakes. To impose liability for all such mistakes would impose substantial costs on companies that would prove unmanageable. Scienter distinguishes actionable from nonactionable misstatements in a way consistent with the common-law definition of fraud. In doing so, scienter can serve as a screen that courts can use to dismiss meritless suits.

Despite its usefulness as a limit, the scienter requirement can create a divergence between Rule 10b-5 and its goal of reducing misstatements that distort the efficiency of the markets. Rather than focusing on the nature of the misstatement and its effect on the market, the scienter requirement shifts the focus to the motivation of individual managers who might have been involved with the misstatement. A scienter requirement may shift Rule 10b-5 away

190. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

191. *Id.* at 214.

192. *Id.* at 193.

from primarily regulating entities and their interaction with the market and toward regulating individual enrichment.¹⁹³

B. The “Concrete Benefits” Test

As the need for limiting the costs of Rule 10b-5 actions has increased, the courts and Congress have fashioned more and more elaborate tests for determining whether a defendant acted with scienter. As this Section shows, these tests have shaped the substance of the scienter requirement so that it increasingly resembles an unjust enrichment test.

Given the costs of discovery and the frequency of securities fraud class actions, courts have developed heightened pleading standards on the issue of scienter.¹⁹⁴ Even in the absence of legislation, some courts required plaintiffs bringing cases under Rule 10b-5 to allege specific facts in the complaint to survive a motion to dismiss.¹⁹⁵ The basis for requiring heightened pleading was Rule 9(b) of the Federal Rules of Civil Procedure,¹⁹⁶ which requires plaintiffs to allege common-law fraud claims with particularity. The Second Circuit took the lead in imposing such a specificity requirement with respect to

193. Some federal circuit courts have further focused Rule 10b-5 on the conduct of individuals as opposed to entities by rejecting the possibility of “collective scienter,” requiring that scienter be established for some particular individual, rather than for the corporation itself. *See, e.g.*, *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190, 195 (2d Cir. 2008) (“To prove liability against a corporation, of course, a plaintiff must prove that an agent of the corporation committed a culpable act with the requisite scienter, and that the act (and accompanying mental state) are attributable to the corporation.”); *Southland Sec. Corp. v. Inspire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) (rejecting “collective scienter” theory); *Nordstrom, Inc. v. Chubb & Son, Inc.*, 54 F.3d 1424, 1435 (9th Cir. 1995) (“[T]here is no case law supporting an independent ‘collective scienter’ theory.”). Such an exclusive focus on individual scienter may not be merited because fraud often originates from dysfunctional groups. *See generally* James Fanto, *Paternalistic Regulation of Public Company Management: Lessons from Bank Regulation*, 58 FLA. L. REV. 859, 904–07 (2006) (arguing that fraud in public companies tends to be the result of dysfunctional group mentalities).

194. Of course, the procedural standard for pleading scienter is not identical to the substantive standard for scienter. However, very few securities fraud class actions proceed past discovery. *See* Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 525 (1991) (citing studies finding that few securities class actions go to trial). Thus, the procedural rather than the substantive standard is in most cases determinative of whether a securities fraud class action will succeed.

195. *See, e.g.*, Hillary A. Sale, *Heightened Pleading and Discovery Stays: An Analysis of the Effect of the PSLRA’s Internal-Information Standard on ‘33 and ‘34 Act Claims*, 76 WASH. U. L.Q. 537, 544–51 (1998) (describing different heightened pleading standards prior to passage of the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.)).

196. FED. R. CIV. P. 9(b).

scienter,¹⁹⁷ reading Rule 9(b) to require that the plaintiff allege a “strong inference of fraudulent intent.”¹⁹⁸ The plaintiff can establish this strong inference “(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness.”¹⁹⁹

Of the two alternatives, recklessness is seen as more difficult to establish. To establish conscious recklessness under the Second Circuit standard, there must be a specific allegation that the defendants “knew facts or had access to information suggesting that their public statements were not accurate” or “failed to check information they had a duty to monitor.”²⁰⁰ Precise evidence that a defendant knew that information was false can be difficult to establish without internal information that cannot be obtained without discovery.²⁰¹

Motive and opportunity are somewhat easier to allege. Certainly, managers who control the corporation will have the opportunity to commit fraud. The main question is whether they have the motive to do so. On the surface, managers have many motives for causing misrepresentations, some of which can be characterized as personal. Managers may want to meet performance targets that result in bonuses, they may want to increase the stock price so that they can profitably exercise stock options, or they may just want to hang onto their jobs. But many managers who commit fraud may do so not for selfish personal reasons but because they believe that doing so serves the interests of the shareholders. For example, a manager might hide bad news because he thinks it will cause panic that will cause a sharp decline in the company’s stock price to a level below what management believes is the stock’s intrinsic value.

The Second Circuit, however, narrowly defined “motive” to encompass only personal, or “concrete,” benefits. It stated that motive “entail[s] concrete benefits that could be realized by one or

197. Sale, *supra* note 195, at 549–51.

198. Shields v. Citytrust Bancorp, Inc., 25 F.3d 1124, 1128 (2d Cir. 1994); *see also* Goldman v. Belden, 754 F.2d 1059, 1070 (2d Cir. 1984) (concluding that “the Complaint alleged a sufficient factual basis to support its allegations of scienter”).

199. Shields, 25 F.3d at 1128.

200. Novak v. Kasaks, 216 F.3d 300, 311 (2d Cir. 2000).

201. *See, e.g.*, Sale, *supra* note 195, at 573–74, 578–79 (noting that the heightened pleading standard effectively requires that the complaint allege internal information to survive a motion to dismiss).

more of the false statements and wrongful nondisclosures alleged.”²⁰² It specifically rejected the notion that general motives—such as making the company appear to be performing better, or even abstract economic self-interest—could be a concrete benefit.²⁰³ Under the Second Circuit’s scienter test, unless there is a specific allegation that a manager will personally benefit from a fraud, the motive element will not be satisfied.

The Second Circuit’s motive-and-opportunity standard and “concrete benefits” test have become even more influential with the passage of the Private Securities Litigation Reform Act of 1995 (PSLRA),²⁰⁴ which adopted a heightened pleading standard with respect to scienter to reduce the incidence of abusive securities fraud litigation.²⁰⁵ The PSLRA requires that the plaintiff plead facts establishing a “strong inference” of fraudulent intent.²⁰⁶

The phrase “strong inference” is deliberately ambiguous,²⁰⁷ and circuit courts have split in deciding how to interpret it. One obvious possibility is that the PSLRA simply adopted the Second Circuit test for pleading scienter.²⁰⁸ And, indeed, after the PSLRA, the Second

202. *Shields*, 25 F.3d at 1130; *see also* *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 170 (2d Cir. 2000) (citing *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124 (2d Cir. 1994), after Congress passed the Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.)).

203. *See, e.g.*, *Kalnit v. Eichler*, 264 F.3d 131, 139 (2d Cir. 2001) (“Insufficient motives, we have held, can include (1) the desire for the corporation to appear profitable and (2) the desire to keep stock prices high to increase officer compensation.”); *Ganino*, 228 F.3d at 170 (“General allegations that the defendants acted in their economic self-interest are not enough.”); *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 268 (2d Cir. 1996) (finding that creating the appearance of investment profit is insufficient); *Shields*, 25 F.3d at 1130 (holding that allegations that “executives aim to prolong the benefits of the positions they hold” are insufficient to survive a motion to dismiss).

204. Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 and 18 U.S.C.).

205. 15 U.S.C. § 78u-4(b)(1)–(2) (2006).

206. *Id.* § 78u-4(b)(2). The Supreme Court recently specified that “[t]o qualify as ‘strong’ . . . an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent.” *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 314 (2007).

207. *See* Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 650–66 (2002) (concluding that the ambiguity of the “strong inference” standard was deliberate and facilitated passage of the PSLRA).

208. There is evidence in the legislative history that Congress modeled the PSLRA after the Second Circuit standard. *See* S. REP. NO. 104-98, at 15 (1995) (stating that “the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit”). *But see* H.R. REP. NO. 104-369, at 41 (1995) (Conf. Rep.) (“Because the Conference Committee intends

Circuit simply retained its motive-and-opportunity standard, including the “concrete benefits” test.²⁰⁹ A number of circuits have since adopted the Second Circuit’s motive-and-opportunity standard,²¹⁰ and some circuits have explicitly adopted the Second Circuit’s “concrete benefits” test.²¹¹

Some circuits have limited the test for scienter even more, finding that motive and opportunity alone do not establish scienter and requiring that a plaintiff plead intentional or reckless conduct at the motion to dismiss stage.²¹² Many circuits do rely upon the Second Circuit test, however, to the extent that they accept motive as a factor for determining whether recklessness has been alleged.²¹³ Some of the

to strengthen existing pleading requirements, it does not intend to codify the Second Circuit’s case law interpreting this pleading standard.”).

209. See *Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); see also *Rothman v. Gregor*, 220 F.3d 81, 92–93 (2d Cir. 2000) (“The key question is motive, namely whether the Appellants adequately alleged ‘concrete benefits that could be realized by one or more of the false statements and wrongful disclosures alleged.’” (quoting *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994))).

210. See, e.g., *Fla. State Bd. of Admin. v. Green Tree Fin. Corp.*, 270 F.3d 645, 659–60 (8th Cir. 2001) (using the Second Circuit’s motive-and-opportunity standard to frame its analysis); *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534–35 (3d Cir. 1999) (holding that plaintiffs can plead scienter by proving motive and opportunity).

211. See *Fla. State Bd. of Admin.*, 270 F.3d at 659 (noting that the Second Circuit test restricts the types of motive that give rise to liability); *Phillips v. LCI Int’l, Inc.*, 190 F.3d 609, 621 (4th Cir. 1999) (citing the Second Circuit in applying the “concrete benefits” test); see also *Oran v. Stafford*, 226 F.3d 275, 290 (3d Cir. 2000) (finding that unusual levels of insider trading could support scienter but not explicitly adopting the “concrete benefits” test).

212. The Ninth Circuit imposed the strictest standard, requiring that the plaintiff plead “deliberate recklessness.” See *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (“In order to show a strong inference of deliberate recklessness, plaintiffs must state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity.”); see also *Marilyn F. Johnson, Karen K. Nelson & A.C. Pritchard, In re Silicon Graphics Inc.: Shareholder Wealth Effects Resulting from the Interpretation of the Private Securities Litigation Reform Act’s Pleading Standard*, 73 S. CAL. L. REV. 773, 774 (2000) (“The Ninth Circuit’s interpretation in *Silicon Graphics* is the most stringent, requiring plaintiffs to allege facts that would show the defendants were ‘deliberately reckless’ in making the misrepresentation that gave rise to the fraud claim.”). Other circuits have rejected the motive-and-opportunity standard but have not required “deliberate” recklessness. See, e.g., *Ottmann v. Hanger Orthopedic Grp.*, 353 F.3d 338, 345 (4th Cir. 2003); *Nathenson v. Zonagen Inc.*, 267 F.3d 400, 410–11 (5th Cir. 2001); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245, 1261–62 (10th Cir. 2001); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1285–86 (11th Cir. 1999); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 551 (6th Cir. 1999).

213. See, e.g., *Ottmann*, 353 F.3d at 345; *Nathenson*, 267 F.3d at 410–11; *City of Philadelphia*, 264 F.3d at 1261–62; *Greebel*, 194 F.3d at 197; *Bryant*, 187 F.3d at 1285–86; *In re Comshare*, 183 F.3d at 551. The Ninth Circuit has also considered motive as evidence of scienter. See *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1064 (9th Cir. 2000) (noting that motive and opportunity can be “considered as circumstantial evidence of [scienter]”).

circuits relying on a recklessness test consider motive in terms of concrete benefits.²¹⁴ For example, the Ninth Circuit has stated that allegations of insider trading are relevant in supporting allegations of recklessness.²¹⁵ The Supreme Court has acknowledged that although motive is not a prerequisite to liability, “personal financial gain may weigh heavily in favor of a scienter inference.”²¹⁶

The Second Circuit’s “concrete benefits” standard is a variant of the unjust enrichment principle. The standard shifts attention from whether the fraud has harmed plaintiff shareholders to whether the defendants have enriched themselves through the fraud. By distinguishing fraud motivated by unjust enrichment from fraud motivated by a desire to fool the market to keep the stock price high, the “concrete benefits” standard draws a somewhat arbitrary line.

Although, in theory, a “concrete benefits” standard need not significantly shift the focus of Rule 10b-5 to unjust enrichment, in practice it has. Because of the need to move beyond a motion to dismiss, there is a natural tendency for plaintiffs’ attorneys to allege facts, such as trading on inside information, to meet the motive-and-opportunity test. Indeed, Robert Thompson and Hillary Sale find that after the enactment of the PSLRA, there has been an increase in the number of allegations relating to insider trading.²¹⁷ In influencing the nature of the cases brought under Rule 10b-5, the “concrete benefits” test affects the type of issues that judges decide, shaping the doctrine defining Rule 10b-5.

One study finds that sufficient allegation of motive is virtually a prerequisite to surviving a motion to dismiss. Ann Morales Olazabal & Patricia Sanchez Abril, *The Ubiquity of Greed: A Contextual Model for Analysis of Scienter*, 60 FLA. L. REV. 401, 404 (2008) (“[O]f the approximately one hundred reported circuit court decisions that have addressed scienter since the passage of the PSLRA, not a single case in which there was no apparent motive—or the motive alleged was practically or economically nonsensical—survived the dismissal stage.”).

214. See, e.g., *Nathenson*, 267 F.3d at 420 (finding that “allegations that corporate officers and directors would benefit from enhancing the value of their stock and/or stock options and that the corporation would benefit by receiving more for its shares to be issued in the July 1997 public offering are likewise insufficient to support a strong inference of scienter”); *City of Philadelphia*, 264 F.3d at 1261–62 (citing the “concrete benefits” test in explaining that motive could be sufficient to support finding of recklessness in certain circumstances).

215. See *Ronconi v. Larkin*, 253 F.3d 423, 434–35 (9th Cir. 2001).

216. *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 325 (2007).

217. Thompson & Sale, *supra* note 18, at 901 (“The use of insider trades as a hook for fraud was increasing before the 1995 Act, but its use has grown since that time, in part to meet the increasingly restrictive pleading standard imposed by Congress and welcomed by the courts.”).

The “concrete benefits” test may also serve as a heuristic that judges use to screen cases.²¹⁸ Indeed, it has spawned a number of sub-heuristics concerning what qualifies as a sufficient concrete benefit.²¹⁹ Nonexpert judges may interpret the existence of a concrete benefit as a prerequisite in pleading scienter, rather than simply one way of establishing scienter.²²⁰ As a result, some suits involving substantial misrepresentations that distort the market might be dismissed at the motion to dismiss stage without further inquiry if there is no evidence of concrete benefits.²²¹

Though narrowing the test for scienter makes the standard simpler to apply, the preoccupation with “concrete benefits” has the danger of creating a substantial disconnect between the efficient-markets view of Rule 10b-5—that its purpose is to deter misstatements that hurt the ability of the market to value stocks—and its actual implementation, which tends to target cases in which individuals are unjustly enriched. Of course, to some extent, there is overlap. When managers manipulate stock prices so they can enrich themselves, the market’s ability to function is often hindered. But there are many cases in which there are substantial misrepresentations that are not motivated by personal benefit. With a “concrete benefits” test, such misrepresentations might not be scrutinized.

218. See, e.g., Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 85 (2002) (noting that judges use heuristics to dismiss cases); Hillary A. Sale, *Judging Heuristics*, 35 U.C. DAVIS L. REV. 903, 923–24 (2002) (noting that courts use the “concrete benefits” test as a heuristic to dismiss cases).

219. See, e.g., *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 54 (2d Cir. 1995) (requiring “unusual insider trading activity” to satisfy the “concrete benefits” test and holding that stock sales of less than 11 percent were not sufficiently unusual); see also *Rothman v. Gregor*, 220 F.3d 81, 94 (2d Cir. 2000) (listing instances in which insider trading has been found to be “unusual”); Sale, *supra* note 218, at 923–44 (describing various insider trading heuristics). *But see In re Scholastic Corp. Sec. Litig.*, 252 F.3d 63, 75 (2d Cir. 2001) (“[N]one of these cases established a *per se* rule that the sale by one officer of corporate stock for a relatively small sum can never amount to unusual trading.”).

220. Generally, heuristics allow nonexpert judges to easily decide complex legal issues. See Bainbridge & Gulati, *supra* note 218, at 84–85.

221. See generally, Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J.L. ECON. & ORG. 598 (2007) (finding that securities fraud class actions without “hard evidence” of fraud are more likely to be dismissed after passage of the PSLRA).

C. Renewed Focus on Individual Liability

In addition to the narrowing of Rule 10b-5's scope by the courts through the "concrete benefits" test, a number of academic proposals would move Rule 10b-5 even closer toward the unjust enrichment principle. For example, a number of prominent commentators have proposed limiting Rule 10b-5's scope by eliminating vicarious liability for securities fraud.²²² For various reasons, it may be preferable to recover damages for securities fraud from individual managers rather than from the corporation. As agents of the corporation, individual managers are the ones who make misrepresentations to the market and may benefit personally from such fraud.²²³ Because unjust enrichment provides the primary incentive for fraud, it might be better to target the individual managers, not the corporations for which they work.

A few commentators have gone even further and argued that securities fraud class actions under Rule 10b-5 should be limited to cases against individuals who are unjustly enriched by misrepresentations to the market.²²⁴ These commentators are skeptical of the utility of requiring the corporation to compensate its shareholders for securities fraud. Compensating injured shareholders with corporate funds arguably requires the shareholders to pay for part of their own compensation because it comes from the corporation that they own.²²⁵ In contrast, a payment from enriched

222. See, e.g., Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 734; Coffee, *Reforming*, *supra* note 55, at 1582.

223. See, e.g., Arlen & Carney, *supra* note 222, at 694 ("We predict that Fraud on the Market generally will be committed by officers and directors seeking to conceal from the market, and from the firm's shareholders, that the firm is ailing in an attempt to save their jobs and their investments in the firm."); Coffee, *Reforming*, *supra* note 55, at 1572 ("The persons most responsible for the accounting irregularities at Enron, Worldcom, and a host of other companies were managers who, beginning in the 1990s, began to be primarily compensated with equity compensation and so had a strong incentive to recognize income prematurely in order to inflate reported income.").

224. See, e.g., Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 3 (2007) ("A [securities fraud class action] should be dismissed for failure to state a claim unless it appears that insiders have enjoyed gains from trading during the fraud period."); Easterbrook & Fischel, *supra* note 106, at 644 (arguing that restitution is an efficient measure of damages in Rule 10b-5 cases); Adam C. Pritchard, 'Basic' Error Is Focus on Loss, NAT'L L.J., Sept. 22, 2008, at 26 (proposing that damages in Rule 10b-5 fraud-on-the-market actions be measured by defendants' gain).

225. In an earlier article, I critique this "circularity problem." See James J. Park, *Shareholder Compensation as Dividend*, 108 MICH. L. REV. 323 (2009).

individuals does not suffer from circularity when it comes from personal rather than corporate funds. Given this circularity problem and the costs of securities fraud class actions, some critics contend it is more efficient to limit damages in securities fraud class actions to the amount by which such individuals are unjustly enriched.²²⁶ If implemented, such a limit would complete the transformation of Rule 10b-5 from an antifraud rule to an unjust enrichment rule.

The proposals to limit Rule 10b-5's reach to individuals who commit insider trading are a natural extension of the tendency of courts to require a showing of concrete benefits before a securities fraud class action may proceed. Oddly, these efforts to narrow the reach of Rule 10b-5 share a commonality with efforts to expand the reach of Rule 10b-5 in that they both rely upon the unjust enrichment principle. At the same time, the narrowing of Rule 10b-5 through use of the unjust enrichment principle may create tensions with the traditional efficient-markets rationale for Rule 10b-5. Part V describes the clash between unjust enrichment and efficient markets and how the two theories might be reconciled.

V. RECONCILING EFFICIENT MARKETS AND UNJUST ENRICHMENT

Ironically, the once-controversial use of Rule 10b-5 to prohibit insider trading is now rarely questioned, whereas the conventional use of Rule 10b-5 to deter deceptive misstatements that distort stock market prices is more and more limited to cases involving insider enrichment. Despite this Article's support for the unjust enrichment principle, this is a troubling development in that encouraging efficient markets should still be considered the primary purpose of Rule 10b-5.

This Part seeks to reconcile the unjust enrichment principle with the traditional efficient-markets conception by describing Rule 10b-5 as having first-order and second-order concerns. The first-order concern reflects the traditional economic goal of encouraging efficient markets. The second-order concern reflects a worry about unjust enrichment that offends public values. Although the efficient-markets concern is the primary purpose of Rule 10b-5, the unjust enrichment principle also plays a significant role in creating limits on the ways in which individuals can unfairly exploit markets.

226. See Easterbrook & Fischel, *supra* note 106, at 634.

A. *Efficient Markets*

Despite the increasing legitimacy of the unjust enrichment principle, this Section contends that courts and policymakers should be wary of thinking of Rule 10b-5 as mainly targeting unjust enrichment. The first-order concern of Rule 10b-5 is to encourage companies to disclose accurate information, enabling markets to function efficiently.²²⁷ Rule 10b-5 should not be reduced to a prohibition of insider trading. This Section discusses a number of areas in which the efficient-markets and unjust-enrichment conceptions are in tension and suggests ways to ensure that the rule's first-order concern is not eclipsed.

The shift to a Rule 10b-5 targeted primarily at insider enrichment is consistent with Paul Mahoney's novel interpretation of the purpose of securities regulation. In a 1995 article, Mahoney argues that mandatory disclosure does more than promote efficient markets: it also checks agency costs.²²⁸ Disclosure by public companies allows investors to monitor self-dealing and shirking by management. Going beyond this descriptive point, Mahoney contends that mandatory disclosure should be limited to information necessary to monitor self-dealing by management.²²⁹ For Mahoney, the cost of disclosure meant to encourage accurate pricing of securities was too high, and thus it might be more efficient if securities regulation focused on the problem of agency costs.²³⁰

Though securities regulation does not limit mandatory disclosure to information necessary to monitor management, securities fraud enforcement is more and more directed at frauds that reflect agency costs. As shown earlier, courts increasingly rely on the heuristic of insider trading in determining whether the scienter requirement has been met, and there have been proposals to limit private enforcement of Rule 10b-5 to cases involving insider trading.²³¹

227. As previously outlined in Part I, the importance of deterring fraud that harms markets is perhaps self-evident. *See, e.g.*, Lynn A. Stout, *Type I Error, Type II Error, and the Private Securities Litigation Reform Act*, 38 ARIZ. L. REV. 711, 713 (1996) (“[T]here is one thing [securities scholars] do agree on: fraud is very, very bad for securities markets.”).

228. *See* Mahoney, *supra* note 3, at 1048.

229. *Id.* at 1089–1104.

230. *See id.* at 1049; *see also* Mahoney, *supra* note 51, at 635 (“Private enforcement of Rule 10b-5 . . . adds nothing to the arsenal of devices (principally the market for corporate control) used to reduce agency losses.”).

231. *See supra* Parts IV.B–C.

Although it may be the case that focusing on fraud motivated by unjust enrichment would be sufficient to deter securities fraud, there is also a danger that limiting fraud liability to cases involving individual enrichment would significantly underdeter.²³² Managers who mislead the market are not always motivated to do so by personal enrichment. Limiting securities fraud class actions to cases involving unjust enrichment would mean that companies would have incentives to deceive the market in a way that cannot be linked back to individual enrichment. Moreover, the magnitude of investor losses caused by a securities fraud is typically much greater than the amount by which individuals may enrich themselves through such fraud. Securities fraud class actions will have no chance of significantly compensating those harmed by fraud if damages are limited to refunding those unjust enrichment gains.

Certainly, the influence of the unjust enrichment principle on securities fraud class actions evidences a concern with administrative costs that must be balanced against the benefits of a strong fraud prohibition. The courts obviously focus on the narrow concept of “concrete benefits” because it provides a higher hurdle for plaintiffs than a broader conception of fraud. Scholars argue for limiting liability to individuals for a similar reason: the substantial costs associated with securities fraud class actions. A restrictive standard for pleading scienter is a convenient way for judges to screen out strike suits that are brought to extort a settlement.

The convenience of narrowing the scienter standard comes at a cost: a growing disconnect between the screening standard and the role of securities fraud class actions as a facilitator of efficient markets. Perhaps the greatest danger of the rise of the unjust enrichment principle is its tendency to shift focus from the first-order concern of efficient markets to what is essentially a second-order concern. The lack of support for the fraud-on-the-market cause of action may partly reflect a growing ambiguity about what securities fraud class actions are supposed to do. To the extent that securities fraud class actions turn on whether there is proof of individual

232. Of course, the heightened pleading standards of the PSLRA do not apply to actions brought by the SEC. That is not to say that the SEC does not consider unjust enrichment in enforcing Rule 10b-5. Enrichment is a factor in determining whether the SEC will seek penalties. Press Release, SEC, Statement of the Securities and Exchange Commission Concerning Financial Penalties (Jan. 4, 2006), *available at* www.sec.gov/news/press/2006-4.htm (“If the corporation is in any other way unjustly enriched, this similarly weighs in support of the imposition of a corporate penalty.”).

enrichment, results will seem arbitrary. Suppose Company A commits the same accounting misstatement as Company B. Managers of both companies are motivated by a desire to increase the stock price, but only Company B is liable because an executive happened to sell a significant amount of stock. If the primary concern is to promote efficient markets, the relevant consideration should be the intent to fool the market rather than personal enrichment.²³³

Courts might better strike a balance between screening meritless cases and maintaining a regime in which Rule 10b-5 consistently encourages efficient markets by not defining scienter exclusively in terms of “concrete benefits.” Fraud that is motivated by a general desire to make the corporation appear to be doing better than it is can be just as harmful to the functioning of a market as fraud that is motivated by a desire to personally benefit through stock sales. Managers are not solely motivated by the desire to line their pockets but may instead commit fraud because they think it will benefit shareholders.²³⁴ Although there is a need to limit the reach of securities fraud class actions, judges should be careful not to use the “concrete benefits” test as an arbitrary heuristic that overly narrows the scope of scienter. Focusing on a heuristic may result in securities fraud class actions drifting further and further from their initial purpose, which is to deter and compensate for material misrepresentations that distort efficient markets.

Because the proposals discussed in Part IV.C would essentially make Rule 10b-5 an unjust enrichment rule, courts should not limit

233. The regime set forth by Section 11 of the Securities Act of 1933 is a more consistent effort to promote efficient markets. See Securities Act of 1933 (Securities Act) § 11, 15 U.S.C. § 77k (2006). The primary factor determining liability under Section 11 is whether the misstatement is material or not. *Id.* Individual directors and officers can evade liability by establishing that they acted with due diligence. *Id.* Of course, the context of Section 11, in which the corporation is acting as a seller of securities, differs from Rule 10b-5 cases, in which the fraud does not relate to the purchase or sale of securities by the corporation. But the Section 11 action is an example of a regime in which liability for securities fraud does not hinge on unjust enrichment.

234. See, e.g., *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) (describing a securities fraud in which management “conceal[ed] bad news in the hope that it [would] be overtaken by good news”); Donald C. Langevoort, *Resetting the Corporate Thermostat: Lessons from the Recent Financial Scandals About Self-Deception, Deceiving Others and the Design of Internal Controls*, 93 GEO. L.J. 285, 296 (2004) (“[F]inancial misreporting is complicated in motivation. It can be self-serving, potentially profitable for the business, or—frequently—both at the same time.”); James C. Spindler, *Vicarious Liability for Bad Corporate Governance: Are We Wrong About 10b-5?*, 12 AM. L. & ECON. REV. (forthcoming fall 2010) (manuscript at 7–14) (on file with the *Duke Law Journal*) (presenting a model in which managers commit fraud to maximize shareholder returns).

Rule 10b-5 actions to insider trading defendants or do away with vicarious liability for securities fraud. Although insider trading is certainly wrong, it does not capture the distinct harm of fraudulent misstatements that distort the market price of a security. The significance of a misstatement does not hinge on whether some individual benefited from it, but on whether reasonable investors would believe the misstatement to be important. Although enforcing norms against corruption helps enable an efficient market, markets also need some assurance about the reliability of information in order to function. Obtaining this assurance requires targeting not only the individuals enriched but also the corporations whose regulatory filings and financial statements are permeated with misstatements.

The increasing focus of securities law on the scienter inquiry, which mainly assesses the enrichment of a defendant, rather than materiality, which evaluates the potential harm to the market of the misstatement, is perhaps the strongest evidence that Rule 10b-5 is becoming an unjust enrichment rule. Reversing this trend may require revival of the materiality standard. The materiality standard may be a better way of managing the administrative costs of Rule 10b-5 while avoiding a conflict with the first-order concern of encouraging efficient markets.²³⁵ In applying the materiality standard, courts would be asking the question that matters—does the misstatement affect the ability of the markets to value a stock?—rather than the secondary question of whether the misstatement was made to enrich an insider. If the materiality standard were defined with sufficient specificity, it could screen cases without merit as ably as the “concrete benefits” standard, keeping administrative costs low.

Courts and policymakers should thus reject efforts to define materiality so broadly that securities fraud liability can be triggered by all forms of unjust enrichment.²³⁶ As I argued in an earlier article, the expansive version of materiality set forth in SAB No. 99 increases the costs imposed by securities fraud class actions.²³⁷ Even minimal inflations of earnings might be material under Rule 10b-5, so long as

235. See, e.g., James J. Park, *Assessing the Materiality of Financial Misstatements*, 34 J. CORP. L. 513, 550 (2009) (proposing that courts should focus on the persistence of financial misstatements in assessing their materiality).

236. It is worth noting that, in *Basic Inc. v. Levinson*, the Supreme Court observed: “We find no authority in [Section 10(b)], the legislative history, or our previous decisions for varying the standard of materiality depending on . . . whether insiders are alleged to have profited.” 485 U.S. 224, 240 n.18 (1988).

237. See Park, *supra* note 235, at 550–52.

the plaintiff can plead that such inflation is associated with insider stock sales or management bonuses. Courts are less able to dismiss meritless securities fraud class actions at the motion to dismiss stage on materiality grounds so long as such allegations are present. Companies should not be liable for every form of unjust enrichment by their agents, but rather should only be liable for the largest and most persistent misstatements that distort their market value.²³⁸ Narrowing the materiality standard would focus securities fraud class actions on the first-order concern of efficient markets rather than the second-order concern of unjust enrichment.

B. *The Unjust Enrichment Principle*

The best way to reconcile the unjust enrichment principle with the conception of Rule 10b-5 as an antifraud rule is to think of unjust enrichment as a distinct but second-order concern. As this Section shows, rather than solely being concerned with economic efficiency, Rule 10b-5 also reflects public values. Although subjecting market participants to liability under a broadly worded principle may cause concern, this Section argues that overenforcement of the unjust enrichment principle is unlikely and offers suggestions for structuring the doctrine that implements the unjust enrichment principle.

1. *The Unjust Enrichment Principle as a Public Value.* Although the efficient-markets purpose of Rule 10b-5 is important, it is undeniable that Rule 10b-5 is also concerned with unjust enrichment. The rise of the unjust enrichment principle reflects the reality that securities regulation is not solely concerned with efficiency²³⁹ but also implements widely recognized public values. Though there are dangers in relying on an unjust enrichment principle—most notably

238. See Park, *supra* note 235, at 518–19 (arguing that vicarious liability for securities fraud should not be triggered by misstatements that are only qualitatively material).

239. Economists are generally not concerned with the distributional issues that are the focus of the unjust enrichment principle. For example, a policy is Kaldor-Hicks efficient when the gains from a policy are greater than the losses, so that the gaining parties could theoretically pay off the losing parties, regardless of whether such a payoff actually occurs. See John R. Hicks, *Foundations of Welfare Economics*, 49 *ECON. J.* 696, 712 (1939) (“If measures making for efficiency are to have a fair chance, it is extremely desirable that they should be freed from distributive complications as much as possible.”); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 *ECON. J.* 549, 550 (1939) (“In all cases . . . where a certain policy leads to an increase in physical productivity, and thus of aggregate real income, the economist’s case for the policy is quite unaffected by the question of the comparability of individual satisfactions . . .”).

that the principle's application may be driven by uninformed populism²⁴⁰—those dangers are likely manageable because of the high transaction costs of the principle's enforcement.

A number of legal scholars have argued that the law reflects important public values that are widely recognized by a community.²⁴¹ The use of the unjust enrichment principle to shape the contours of Rule 10b-5 might be characterized as an application of a public value.²⁴² The unjust enrichment principle is rooted in societal norms reflected in many areas of the law. Ronald Dworkin notes the existence of a common law principle that “[n]o one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime.”²⁴³ Similarly, statutory and constitutional prohibitions against government corruption reflect the idea that if government officials profit personally from their offices, government will be less likely to operate for the public interest.²⁴⁴

240. See, e.g., Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look Ahead at the Next Decade*, 7 YALE J. ON REG. 149, 210–12 (1990) (criticizing the SEC's use of the “Small Dollar program” to achieve “high visibility and [a] publicly-favorable response”); cf. Crane, *supra* note 17, at 1162–63 (discussing the belief that “the general public often overreacts to risks, thus prompting excessive levels of risk regulation” in the context of antitrust).

241. See, e.g., William N. Eskridge, Jr., *Public Values in Statutory Interpretation*, 137 U. PA. L. REV. 1007, 1015 (1989) (“The core idea of public values scholarship is that there are at least some values . . . that have worth and contribute to the moral growth of our society.”); Owen M. Fiss, *The Supreme Court, 1978 Term—Foreword: The Forms of Justice*, 93 HARV. L. REV. 1, 11 (1979) (noting that constitutional provisions reflect public values that “give our society an identity and inner coherence—its distinctive public morality”); Cass R. Sunstein, *Naked Preferences and the Constitution*, 84 COLUM. L. REV. 1689, 1692 (1984) (“[T]he Constitution requires all government action to be justified by reference to some public value.”).

242. Elsewhere, I argue that principles-based enforcement actions by securities regulators often reflect public values. See, e.g., Park, *supra* note 17, at 668 (“By articulating public values, [principles-based enforcement actions] may decisively address public concerns.”).

243. Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 23–24 (1967) (quoting *Riggs v. Palmer*, 115 N.Y. 506, 511 (1889) (internal quotation marks omitted)).

244. See generally Zephyr Teachout, *The Anti-Corruption Principle*, 94 CORNELL L. REV. 341 (2009) (arguing that a primary concern of the U.S. Constitution is addressing corruption). Corruption can distort the political process on which any democracy relies. It does so in at least two ways. First, it results in a system in which the political process reflects the interests of a few rather than the collective will of the public. See, e.g., *McConnell v. FEC*, 540 U.S. 93, 153 (2003) (“Just as troubling to a functioning democracy as classic *quid pro quo* corruption is the danger that officeholders will decide issues not on the merits or the desires of their constituencies, but according to the wishes of those who have made large financial contributions valued by the officeholder.”). Second, it results in a system in which those who are elected to serve the public instead enrich themselves. See, e.g., Teachout, *supra*, at 373–74 (“To the delegates, political corruption referred to self-serving use of public power for private ends, including, without

At its core, the unjust enrichment principle applied to the securities regulation context sets limits on the extraction of wrongful gains from securities markets. Even if those limits are not always clear, it is undeniable that they exist. The principle is partly premised on the idea that in American society, markets are meant to increase social welfare.²⁴⁵ To the extent that markets primarily benefit only a few privileged individuals, they are not fulfilling their social function. Such a principle is not based solely on economic considerations but is a public value grounded on moral considerations.

Although at first glance it seems that the unjust enrichment principle has little applicability to securities markets, which are premised on the idea that some market participants will enrich themselves over others, there is a consensus that certain types of enrichment go too far and are therefore unjust. Just as government will not function if it is permeated by corruption, there is a sense that markets permeated with unjust enrichment will ultimately fail.²⁴⁶ Steve Thel has found that the legislative history of Section 10(b) of the Securities Exchange Act of 1934 reflects a concern with preventing market manipulation rather than solely a desire to target fraud.²⁴⁷ Donald Langevoort notes that insider trading enforcement is motivated by expressive considerations and a fear that “market norms too easily create subcultures that glorify and rationalize selfishness.”²⁴⁸ The unjust enrichment principle is also reflected in the

limitation, bribery, public decisions to serve private wealth . . . and use by public officials of their positions of power to become wealthy.”).

245. See, e.g., Robert B. Ahdieh, *Making Markets: Network Effects and the Role of Law in the Creation of Strong Securities Markets*, 76 S. CAL. L. REV. 277, 283–96 (2003) (describing the positive social welfare implications of network effects on markets); John F. Berry III, *The Economics of Outsider Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1315–19 (1981) (arguing that the purpose of securities markets is Pareto optimal resource allocation); Dalia Tsuk, *Corporations Without Labor: The Politics of Progressive Corporate Law*, 151 U. PA. L. REV. 1861, 1906 (2003) (describing the acceptance of markets by progressives for instrumental reasons).

246. See, e.g., David Mills & Robert Weisberg, *Corrupting the Harm Requirement in White Collar Crime*, 60 STAN. L. REV. 1371, 1438 (2008) (“The public law doctrines punishing supposed injuries to honest government have begun to blend with, or morph into, doctrines punishing actions alleged to cause diffuse harms to the honesty of the capital markets.”).

247. See Thel, *supra* note 3, at 409 (“[S]urely, one trying to explain the enactment and objectives of the Exchange Act cannot forget that in 1934 there was a widespread consensus that excessive stock market speculation and the collapse of the stock market had brought down the economy, and that those who enacted the Exchange Act were primarily concerned with preventing a recurrence.”).

248. Donald C. Langevoort, *Rereading Cady, Roberts: The Ideology and Practice of Insider Trading Regulation*, 99 COLUM. L. REV. 1319, 1328 (1999).

Sarbanes-Oxley Act of 2002,²⁴⁹ which requires top executives to disgorge bonuses that they received based on financial results that were later found to be false.²⁵⁰

It is telling that both those who would expand the reach of Rule 10b-5 and those who would limit its reach agree on one thing: unjust enrichment is a category of conduct that is particularly significant. Even the Delaware Court of Chancery, not known for its inclination to regulate with a heavy hand, applied the unjust enrichment principle in a case against HealthSouth founder Richard Scrushy when there was earnings manipulation but a civil fraud case could not proceed because of a pending criminal case.²⁵¹ The court required Scrushy to pay millions of dollars in restitution to HealthSouth without a finding of any culpable intent.²⁵² Even if not all would agree with respect to the unjust enrichment principle's scope, there seems to be a consensus that the principle matters.

249. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

250. *See id.* § 304, 116 Stat. at 778 (codified at 15 U.S.C. § 7243 (2006)).

251. In a derivative case, the Delaware Court of Chancery granted a motion for summary judgment in favor of shareholder plaintiffs who pressed a state law unjust enrichment claim against Scrushy, who had paid back a \$25 million loan from HealthSouth with HealthSouth stock that later collapsed in value. *In re HealthSouth S'holders Litig.*, 845 A.2d 1096, 1099–1100 (Del. Ch. 2003), *aff'd*, 847 A.2d 1121 (Del. 2004). Because Scrushy was subject to a criminal proceeding, the plaintiffs did not contend that he acted with intent or that he knew that HealthSouth's financial statements were inflated. *Id.* at 1103 n.10. Instead, they argued that, regardless of whether Scrushy defrauded the company, he was unjustly enriched by the transaction and the transaction should be rescinded. *Id.* at 1103.

Vice Chancellor Strine noted that in Delaware, unjust enrichment is defined broadly as “the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience.” *Id.* at 1105 (citing *Schock v. Nash*, 732 A.2d 217, 232–33 (Del. 1999)). Strine noted that Scrushy was in a position of superior knowledge with respect to the contents of HealthSouth's financial statements. *Id.* at 1106. Even without fraudulent intent, Strine found a substantive unjust enrichment claim, explaining: “Whether or not Scrushy breached any cognizable duty in signing those statements, he was undoubtedly unjustly enriched when the company of which he was a fiduciary bought back shares from him at a price inflated by false financial statements he had signed.” *Id.*

The Delaware Chancery's decision in *Matter of HealthSouth Shareholders Litigation*, 845 A.2d 1096 (Del. Ch. 2003), *aff'd*, 847 A.2d 1121 (Del. 2004), is consistent with a pattern identified by Edward Rock in which Delaware courts apply broadly worded standards through adjudication to create narratives that instruct directors and officers with respect to their duties. *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997) (“[T]he Delaware courts fill out the concept of ‘good faith’ through fact-intensive, normatively saturated descriptions of manager, director, and lawyer conduct, and of process—descriptions that are not reducible to rules . . .”).

252. *In re HealthSouth*, 845 A.2d at 1106.

2. *Translating the Unjust Enrichment Principle into Doctrine.*

The unjust enrichment principle is more controversial than the efficient-markets conception of Rule 10b-5. As a general matter, public values, which reflect moral judgments, are more likely than economic analyses to involve difficult choices between competing considerations.²⁵³ For the unjust enrichment principle to continue to be relevant, courts must feel comfortable translating it into doctrine. Though vagueness may be an inevitable shortcoming of the unjust enrichment principle, the doctrinal framework set forth by the Supreme Court in *O'Hagan* is a useful starting point that with modification may be workable.

Despite the wide recognition of the unjust enrichment principle, there are a number of objections that could be raised to the use of Rule 10b-5 to enforce the principle. First, the expansion of Rule 10b-5 reflects a general increase in federal involvement with corporate governance that might stifle a “race to the top.”²⁵⁴ It might be more appropriate for state corporate law to regulate unjust enrichment than for federal securities law to do so.²⁵⁵ Second, an unjust enrichment principle can evoke moralistic thoughts of class resentment and redistribution.²⁵⁶ In times of economic crisis, the public tends to focus on the great wealth captured by those who work

253. See, e.g., Dan M. Kahan, *The Secret Ambition of Deterrence*, 113 HARV. L. REV. 413, 417 (1999) (arguing that deterrence rhetoric and analysis of its costs and benefits “elides the points of moral contention that motivate public positions on . . . disputed issues”).

254. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1595 (2005) (“[S]tates can be expected to be more effective in setting the appropriate corporate governance default rules than Congress or the SEC.”). But see Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793 (2006) (arguing that federal intervention has protected investors).

255. Although insider trading is now covered by federal law, it might have been conceptualized as a breach of the state fiduciary duty of loyalty. See, e.g., Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 123 (1998) (arguing that the harm of insider trading could be addressed by state law); see also Bainbridge, *supra* note 134, at 1266–68 (arguing that courts should incorporate state law in interpreting federal insider trading prohibition).

256. See, e.g., Langevoort, *supra* note 248, at 1329 (noting, with respect to insider trading prohibitions, that “there may be an emotional component in which envy and frustration at the wealth and power of economic elites, and resulting mistrust, also play a role”); Jonathan Weisman, Sudeep Reddy & Liam Plevin, *Political Heat Sears AIG: Obama Vows to Block Bonuses, But It May Be Too Late*, WALL ST. J., Mar. 17, 2009, at A1 (describing outrage at bonuses paid to employees of AIG).

in the securities industry.²⁵⁷ Calls for reform are often rooted in nothing more than a sense that an injustice has occurred.²⁵⁸ Third, the unjust enrichment principle is problematic because of its vagueness. Due process requires reasonable notice as to the conduct that will incur a government sanction.²⁵⁹ Unlike the antifraud rule, which points to a particular type of misconduct—misleading representations or omissions—the unjust enrichment principle does not single out any particular misconduct as actionable. As a result, an unjust enrichment principle gives regulators and courts a great deal of discretion to define the contours of Rule 10b-5 in unpredictable ways.²⁶⁰

At their core, these objections are based on a fear of overenforcement. But overenforcement may be less of a problem for unjust enrichment claims than it is for securities fraud class actions. Because the unjust enrichment principle targets gains by individuals, the potential recovery is often smaller than for a securities fraud that harms thousands of shareholders, and thus is less likely to attract entrepreneurial plaintiffs. Because they usually deal with individual transactions, unjust enrichment claims are not as susceptible to aggregation through class actions as fraud claims. And as seen in the context of insider trading, unjust enrichment claims can be difficult to establish. As a result, unjust enrichment claims are most likely to be brought by government enforcers, who may have fewer incentives to overenforce.²⁶¹ Enforcers might use limited resources to target the

257. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 110–13 (1994) (describing populist influence on securities regulation).

258. See, e.g., Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. U. L.Q. 849, 851 (1997) (“[M]any people argued . . . that securities trading was harmful because it was a zero-sum game, in which repeat players could make consistent gains at the expense of wave after wave of neophytes.”).

259. See, e.g., *City of Chicago v. Morales*, 527 U.S. 41, 56 (1999) (“It is established that a law fails to meet the requirements of the Due Process Clause if it is so vague and standardless that it leaves the public uncertain as to the conduct it prohibits”) (quoting *Giaccio v. Pennsylvania*, 382 U.S. 399, 402–03 (1966)).

260. A number of commentators have noted the tendency of the SEC to engage in “regulation by enforcement.” See, e.g., ROBERTA KARMELE, *REGULATION BY PROSECUTION* 336 (1982) (“[T]he SEC has abused its prosecutorial independence by transforming its enforcement program into a policy-making, and, therefore, highly political tool.”); Pitt & Shapiro, *supra* note 240, at 155. *But see* Park, *supra* note 17, at 635–41 (critiquing the “regulation by enforcement” argument).

261. See, e.g., Amanda M. Rose, *Reforming Securities Litigation Reform: A Proposal for Restructuring the Relationship Between Public and Private Enforcement of Rule 10b-5*, 108 COLUM. L. REV. 1301, 1304 (2008) (“A monopolistic public enforcer can deal with the overdeterrent potential of an overbroad liability rule through use of discretionary

most egregious, clear-cut cases of securities-related unjust enrichment. This enforcement might both deter the undesirable conduct and have an expressive value in applying public values to the securities markets.

Moreover, many of the concerns about overenforcement might be met through further definition of the doctrinal test that implements the unjust enrichment principle. As noted earlier, *O'Hagan* can be read as setting forth three elements for a Rule 10b-5 unjust enrichment claim.²⁶² The unjust enrichment principle applies to (1) deceptive conduct (2) coinciding with a securities transaction (3) that enriches some individual at the expense of others.

The first element, deceptive conduct, increases the range of Rule 10b-5 because, unlike the antifraud rule, it does not require a specific misrepresentation or omission directed at the market or investors. Under the unjust enrichment principle, a broader range of conduct—such as theft, manipulation, or an undisclosed special arrangement—is sufficient to trigger Rule 10b-5. Though it attaches to a wider range of conduct, the requirement of deception provides a significant limit to the reach of the unjust enrichment principle. One way of further limiting the unjust enrichment principle would be to require a showing of intentional misconduct.²⁶³ The concern that the principle is too vague might be partially met by reserving its application to the worst forms of misconduct. Limiting the unjust enrichment principle to intentional misconduct might help ensure that enforcement focuses on cases in which there is more likely to be social consensus that the conduct in question is wrong.

Perhaps a natural limit on the reach of the unjust enrichment principle is that the opportunity for deceptive schemes varies depending on the status of the individual as a fiduciary, an agent, or an outsider.²⁶⁴ Obviously, the fiduciary has the greatest opportunities to deceive. Fiduciaries are trusted to make a wide range of decisions on behalf of those who may not be sophisticated or have the ability to monitor the fiduciary. The fiduciary is given a great degree of trust

nonenforcement, or by pursuing a cooperative approach to regulation, and it can adjust its approach if it appears to have gotten the deterrence calculus wrong.”).

262. See *supra* Part II.C.

263. In contrast, a traditional Rule 10b-5 securities fraud action can proceed with a showing of recklessness. *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1128 (2d Cir. 1994).

264. In the context of insider trading, “outsider” often refers to a person with an agency relationship to the corporation. Here, “outsider” simply refers to an individual without a relevant fiduciary or agency relationship.

and thus significant opportunities to engage in deceptive conduct without fear of discovery.

Like the fiduciary, the agent also is entrusted to act on behalf of a principal, who may not be able to monitor the agent. The difference between the agent and fiduciary is that the agent's responsibilities are usually narrower. The unjust enrichment principle may thus be relevant to a narrower range of conduct with respect to the agent.

Finally, the outsider has no obligations or power and thus has limited opportunity for deception. The outsider will have to take extreme measures, such as theft, to obtain enrichment. Given the costs of such measures, deceptive conduct by outsiders that could be subject to the unjust enrichment principle will be less common than such conduct by fiduciaries and agents.

The second element of the *O'Hagan* test, the requirement that unjust enrichment coincide with a securities transaction, can also serve as an important limit on the type of wrongful conduct that might trigger Rule 10b-5. Not just any wrongful conduct triggers Rule 10b-5; rather, there must be a substantial connection to a securities transaction. Thus, if someone embezzles money from a bank and invests the money in a stock, that might satisfy the deceptive conduct element of the unjust enrichment test, but there would be enough of a disconnect between the initial theft and subsequent investment so that the second element of coinciding with a securities transaction would not be met.²⁶⁵

The third element, the requirement of enrichment by an individual, might naturally be limited by the requirement that unjust enrichment liability can only be triggered if the enrichment occurs at the expense of others. A likely criticism of the Rule 10b-5 unjust enrichment principle is that it arguably jettisons traditional limits to Rule 10b-5, such as fiduciary and agency relationships, and leaves only an amorphous concept of wrongfulness. The third element could

265. In addition, to partly meet the concern of preempting state law, Rule 10b-5 unjust enrichment claims might be limited to securities transactions on a national exchange. Other securities transactions might be better regulated through state unjust enrichment law. State unjust enrichment laws differ from the Rule 10b-5 unjust enrichment principle in that some states do not require an element of deception. See *In re HealthSouth S'holders Litig.*, 845 A.2d 1096, 1099 (Del. Ch. 2003), *aff'd*, 847 A.2d 1121 (Del. 2004) (“[N]either [unjust enrichment nor equitable fraud] is dependent on Scrusby’s actual knowledge of the inaccuracy of HealthSouth’s financial information.”). In contrast, some deceptive conduct (though not necessarily a specific misrepresentation directed at the market) is required to support a Rule 10b-5 unjust enrichment claim. See 17 C.F.R. § 240.10b-5 (2010).

be modified in such a way as to meet this objection so that although a fiduciary or agency relationship is not a prerequisite to triggering the unjust enrichment principle, the difficulty of establishing this element might differ based on whether the individual is a fiduciary, an agent, or an outsider. Given their broadly defined duties to shareholders, fiduciaries might face a rebuttable presumption that wrongful enrichment occurred at the expense of others. With agents and outsiders, there might be no presumption, and it would be the plaintiff's burden to prove that the wrongful enrichment occurred at the expense of others.

3. *Application of the Unjust Enrichment Principle.* The application of this test can be illustrated by a simple example relating to a possible extension of the unjust enrichment principle. In light of the recent public backlash against excessive compensation packages,²⁶⁶ one can imagine circumstances in which Rule 10b-5 could be used to challenge stock-based compensation obtained through misconduct. Such unjust enrichment relating to securities obtained as executive compensation would be difficult to distinguish from insider trading by agents prohibited in *O'Hagan*.

Envision a case in which the CEO of a publicly traded company is negotiating with the board and deliberately submits false information to the board's compensation committee, knowing it will be used in determining the CEO's compensation, much of which is in the form of stock and stock options.

Under a narrow antifraud reading of Rule 10b-5, such misconduct might not be actionable. The misrepresentation is not

266. See, e.g., Ian Bremmer & Sean West, *AIG and "Political Risk,"* WALL ST. J., Mar. 20, 2009, at A15 ("The bonuses represent greed in the face of dire circumstances, which resonates with Joe the TARP-funder."); Weissman et al., *supra* note 256 (describing outrage at bonuses paid to employees of AIG). On July 30, 2009, New York Attorney General Andrew Cuomo released a report detailing bonuses paid to various employees of banks receiving government bailout funds. See ANDREW M. CUOMO, NO RHYME OR REASON: THE "HEADS I WIN, TAILS YOU LOSE" BANK BONUS CULTURE (2009). The report sparked a flurry of front-page articles questioning how compensation could remain so high despite the losses suffered by the banks. See, e.g., Susanne Craig & Deborah Solomon, *Bank Bonus Tab: \$33 Billion,* WALL ST. J., July 31, 2009, at A1; Louise Story & Eric Dash, *Bankers Reaped Lavish Bonuses During Bailouts,* N.Y. TIMES, July 31, 2009, at A1. It is important to note that the criticism of executive compensation practices is not limited to populists. See, e.g., LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 1 (2004) ("[O]ne economist has calculated that the dramatic growth in executive pay during the 1990s was outpaced by the increase in the volume of research papers on the subject.").

directed at investors or the market, and it might not be material even if it had been so directed.

There could, however, be a cause of action under the modified *O'Hagan* test for unjust enrichment. First, there is deceptive misconduct. This is a prime example of the broad range of contexts in which fiduciaries have the opportunity for deceptive enrichment.²⁶⁷ If a CEO influences the process by which his compensation is set, he has a unique ability to manipulate the process. If his deception is intentional, it is especially blameworthy. Second, the deceptive misconduct is in connection with a security—stock-based compensation. The deception allowed the CEO to obtain more stock than he merited. Finally, because the CEO is a fiduciary, there would be a rebuttable presumption that the inflated compensation came at the expense of shareholders.

Such a use of Rule 10b-5 no doubt would be controversial, but courts could conceivably uphold it as an extension of *O'Hagan*. If such a case succeeds, it would only be the latest step in the gradual expansion of Rule 10b-5 based on the unjust enrichment principle.

CONCLUSION

Rule 10b-5 is now much more than a provision that “catches fraud.” Although it has primarily been an antifraud rule that facilitates efficient markets, Rule 10b-5 is also shaped by an unjust enrichment principle covering deceptive conduct related to a securities transaction that enriches an individual. The increasing use of the unjust enrichment principle has not only expanded the reach of Rule 10b-5 but also has limited it in important ways. Rather than being unrelated areas of law, insider trading and securities fraud doctrine are both increasingly shaped by the unjust enrichment principle.

Courts, regulators, and academics should all recognize the important role played by the unjust enrichment principle in the context of Rule 10b-5. At the same time, courts should be wary of relying on the second-order concern of unjust enrichment to the extent that it unduly diverts Rule 10b-5 from its first-order concern of deterring material misrepresentations about a stock that prevent

267. The question might be more difficult if there were only a failure to disclose rather than an affirmative deception. *Cf.* Langevoort & Gulati, *supra* note 165, at 1656–67 (examining the question of whether fiduciaries have a duty to disclose in transactions with company shareholders).

markets from functioning efficiently. Rather than using the narrow “concrete benefits” scienter test as a way of separating good claims from bad, a stricter materiality standard is a more promising way of ensuring that securities fraud class actions are limited to misstatements that impact the market.

Perhaps the main lesson of the unjust enrichment principle is that securities regulation is about more than efficient markets. There is a strong case, reflected both in Rule 10b-5 doctrine and in academic commentary, that public values play some role in regulating the conduct of market participants. Although there are qualms about allowing populism to influence the regulatory regime, the reality is that values such as the unjust enrichment principle continue to play an important role in securities regulation. Many see a test for unjust enrichment as unworkable; however, overenforcement is unlikely, and the Supreme Court’s decision in *O’Hagan* suggests a doctrinal foundation that can be modified so that a workable Rule 10b-5 unjust enrichment principle can continue to develop.