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Insider Trading Jurisprudence After United States v. O'Hagan: A Restatement (Second) of Torts 551(2) Perspective

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NOTE

INSIDER TRADING JURISPRUDENCE AFTER *UNITED STATES V. O'HAGAN*: A *RESTATEMENT (SECOND) OF TORTS* § 551(2) PERSPECTIVE

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It is of the essence of the economic function of a securities exchange that it be a free market—free of the artificiality of manipulation (the laying of hands on the scales) as it is free of the unfairness of insider trading (playing cards with a marked deck).[1]

INTRODUCTION

When a corporate officer uses confidential corporate information in trading in his corporation's securities, his conduct constitutes illegal insider trading.[2] But what happens when that officer, because of his corporate position, gains confidential information about *another* corporation's stock and then trades on that information? As an "outsider," does his conduct then constitute illegal insider trading? Intui-

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[1] LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 930 (3d ed. 1995).

[2] This is known as classical insider trading. *See infra* Part II.A.1.

tively, anyone who possesses confidential information about a stock seems like an "insider."[3] Thus, the unwary public might expect that those individuals privy to this information—whether inside or outside the corporation—may not trade. Until the Supreme Court's decision in *United States v. O'Hagan*,[4] however, the courts stood divided as to whether the federal securities laws prohibited this "outsider" trading on inside information.[5]

Why the controversy? How could the law prohibit insiders but not outsiders from trading on nonpublic corporate information?[6] One reason is that the vague language of section 10(b) of the Securities Exchange Act of 1934 ("the Act")[7] and Securities and Exchange Commission ("SEC") Rule 10b-5,[8] which is relevant in most insider trading cases, fails to define "insider trading."[9] Another reason for the outsider trading controversy is the Supreme Court's reliance on fiduciary relationships instead of the possession of inside information.[10] In *O'Hagan*, the Supreme Court attempted to resolve this problem of "outsider trading," but its adoption of a theory based on the misappropriation of information created several analytical and practical difficulties.[11]

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3 For example, someone who appreciates an "inside joke" is anyone who possesses pertinent background information. When the term "insider" appears in the context of securities laws, however, the meaning refers only to officers, fiduciaries, or others in a similar position of trust or confidence. *See* FED. SEC. CODE § 1603(b) (1980). Although these individuals most likely possess the requisite information, the term "insider" nonetheless refers to a person's status and not to his knowledge.

4 521 U.S. 642 (1997).

5 For an account of the division among the circuits, see *infra* Part II.D.

6 Federal mail and wire fraud statutes may prohibit this conduct. *See infra* Part II.C.1; *see also* Brief of *Amici Curiae* North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner at 6, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842) (stating that "the federal mail and wire fraud statutes independently prohibit most misappropriation"). In addition, state corporate law probably would police internal corporate affairs. *See infra* note 310 and accompanying text.

7 15 U.S.C. §§ 78a-78mm (1994 & Supp. III 1997).

8 17 C.F.R. § 240.10b-5 (1998).

9 *See infra* notes 24-25 and accompanying text.

10 *See* Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-*Chiarella *Restatement*, 70 CAL. L. REV. 1, 3 (1982) (indicating that the Supreme Court "has made the fiduciary principle a consideration of utmost importance").

11 The actual harm of insider trading is open to debate. There is a strong intuition that insider trading is unfair. *See id.* at 2 (stating that the "acceptance [of laws prohibiting insider trading] seems to rest more on the strongly held intuition that insider trading is unfair"); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1161 (1997) ("The most common argument against insider trading is the intuitive feeling that such behavior is simply unfair or immoral."). One commentator theorized that allowing insider trading eventually would adversely affect *all* shareholders—not just those "victims" of insider trading—by widening the bid-asked price spread of a security:

> The upshot is that this defensive reaction of market makers affects all shareholders, reducing the price at which shareholders can sell and raising the price at which investor must buy. More importantly, the injury is felt

The Supreme Court's decision in *O'Hagan* significantly departs from prior insider trading law. It has induced a number of commentators to debate the validity of the misappropriation theory, to evaluate the current state of insider trading jurisprudence, and to propose how Congress, the SEC, and the Court can clarify this area of law.[12] While this Note likewise discusses the merits of the misappropriation theory and its impact on securities law, it also attempts to offer a new approach to insider trading theory and a new solution to the insider trading problem. This Note examines the evolution of insider trading law from its pre-*Chiarella*[13] origins, and it rethinks insider trading theory from the perspective of the fraudulent nondisclosure doctrine of *Restatement (Second) of Torts* § 551(2)(e).[14] This Note then proposes

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> not only by those trading in the stock of the particular company in which the insider trader is active, but by all shareholders trading in all stocks. . . .
>
> The key point here is that the victims of insider trading are not simply those who traded with the party possessing inside information, but rather all shareholders, who must trade in less efficient markets because of the market makers' need to protect themselves.

John C. Coffee, Jr., *Is Selective Disclosure Now Lawful?*, N.Y. L.J., July 31, 1997, at 5. On the other hand, some commentators have argued that a closer analysis reveals that insider trading is not more unfair than other accepted transactions. *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983) (arguing that insider trading is desirable and that it promotes market efficiency because it aids the dissemination of information). This Note will assume the Supreme Court's position: insider trading—trading on nonpublic information—threatens the integrity of otherwise honest and fair markets. *See* United States v. O'Hagan, 521 U.S. 642, 658-59 (1997).

12 *See, e.g.*, Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289 (1998) (tracing the development of the misappropriation theory and comparing fraud-by-silence in insider trading law to analogous contexts in the past two centuries); Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After* United States v. O'Hagan, 84 VA. L. REV. 153 (1998) (criticizing the Court's adoption of the misappropriation theory, suggesting methods of utilizing the theory effectively against insider trading, and proposing ways that Congress or the SEC can better define insider trading laws); 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 (1998) (praising the Supreme Court's adoption of the misappropriation theory and arguing that the misappropriation theory is superior to the classical theory); Joel Seligman, *A Mature Synthesis:* O'Hagan *Resolves "Insider" Trading's Most Vexing Problems*, 23 DEL. J. CORP. L. 1 (1998) (contending that the Supreme Court's adoption of the misappropriation theory provides a workable definition of insider trading and clarifies prior insider trading decisions, but adding that it will not necessarily lead to predictable results); Elliott J. Weiss, United States v. O'Hagan*: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395 (1998) (describing *O'Hagan* as a resolution of a perceived tension between constructive and informational fraud, praising the misappropriation theory as a siguificant step toward a comprehensive regulatory framework for insider trading, and indicating the remaining areas that insider trading theory must address).

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

14 One commentary proposes applying the "latent defect" doctrine to insider trading and invokes section 551(2)(e). *See* Ronald F. Kidd, Note, *Insider Trading: The Misappropriation Theory Versus an "Access to Information" Perspective*, 18 DEL. J. CORP. L. 101, 108 n.31 (1993). Kidd's commentary, however, does not analyze the applicability of the section 551(2)(e) doctrine in depth. In particular, it does not demonstrate how insider trading theory escapes *Chiarella*'s assertion that possession of material, nonpublic information by

that joint enforcement of this nondisclosure doctrine by the securities exchanges and the judiciary may achieve adequate insider trading regulation.

Part I discusses the emergence of section 10(b) and Rule 10b-5 as the governing law in insider trading jurisprudence. Although section 10(b) and Rule 10b-5 are not specific in their regulation of insider trading, early interpretations of the statutory and regulatory language have articulated notions of contractual fairness. This Part examines the origin of insider trading liability theory, which arose from this fairness-oriented approach.

Part II explores the Supreme Court's treatment of insider trading liability and the subsequent development of insider trading regulation. During this period, the Supreme Court entertained fairness-oriented theories, fiduciary-based theories, and a non–"insider trading" case involving Rule 10b-5; lower courts debated the applicability of the misappropriation theory to section 10(b); and the SEC promulgated Rule 14e-3(a).[15]

Part III discusses the *O'Hagan* decision. In *O'Hagan*, the Supreme Court adopted the misappropriation theory, holding that a section 10(b) violation occurs when an individual commits an undisclosed breach of fiduciary duty by secretly trading securities on entrusted confidential information.[16] The Court also recoguized to some extent the validity of Rule 14e-3(a) and maintained that federal mail and wire fraud statutes may reach insider trading.[17]

Part IV analyzes the misappropriation theory of *O'Hagan*. This Part discusses the theory with respect to the requirements of section 10(b), the policy behind section 10(b), its consistency with prior case law, and its practical application. It argues that the misappropriation theory is problematic in these areas and that insider trading jurisprudence needs a new approach.

Part V examines the insider trading problem from the perspective of *Restatement (Second) of Torts* § 551(2)(e). The "basic facts" doctrine of section 551(2)(e) is superior to the misappropriation theory because it directly addresses the perceived problem of insider trading: insider trading constitutes cheating in a game in which every trader may possess or have access to certain basic information. This Part debunks possible reasons for the Court's failure to adopt an approach

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itself does not give rise to a duty to disclose. *See infra* note 69. Kidd also proposes a return to Professor Brudney's "access to information" theory. *See* Kidd, *supra*, at 106 & n.23. For a discussion of this theory, see *infra* Part II.A.3.

15 17 C.F.R. § 240.14e-3(a) (1998).

16 *See O'Hagan*, 521 U.S. at 647.

17 *See id.* at 676-78.

based on section 551(2)(e), and it demonstrates how section 551(2)(e) is applicable to insider trading.

Part VI offers a solution to the insider trading problem. This Part proposes that the law allow exchanges to promulgate certain disclosure rules that would facilitate the enforcement of section 10(b) violations. The rules and the section 551(2)(e) doctrine would allow courts to apply section 10(b) to both insider and outsider trading.

I

THE DEVELOPMENT OF INSIDER TRADING LIABILITY

A. Securities Exchange Act Section 10(b) and SEC-Promulgated Rule 10b-5

The stock market crash of 1929 and the ensuing Great Depression prompted Congress to pass extensive legislation[18] to regulate the securities industry and to prevent the recurrence of a national economic crisis.[19] Specifically, Congress passed the Securities Exchange Act of 1934[20] with the goal of promoting the fairness and integrity of the securities markets.[21] Congress perceived that insider trading could pose a threat to the market,[22] and under section 16 of the Act, it prohibited corporate directors, officers, and controlling shareholders from engaging in short-swing trading.[23] Even though section 16 prohibits trading regardless of whether the insider actually uses inside information, its purpose is to prevent the unfair use of information in securities trading.[24] Congress adopted this overinclusive rule to avoid problems of proof.[25]

The Securities Exchange Act does not expressly prohibit the use of inside information in trading. To reach unforeseen or otherwise unproscribed deceptive devices, however, the drafters of the Act also

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18 *See* Securities Act of 1933, 15 U.S.C. § 77a-aa (1994 & Supp. II 1996); Securities Exchange Act of 1934, 15 U.S.C. § 78a-jj (1994 & Supp. II 1996); Trust Indenture Act of 1939, 15 U.S.C. § 77aaa-bbbb (1994 & Supp. II 1996); Investment Company Act of 1940, 15 U.S.C. § 80a-1 to -52 (1994 & Supp. II 1996); Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 to -21 (1994 & Supp. II 1996).

19 *See* S. REP. No. 73-792, at 2, 3 (1934).

20 Ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a-78mm (1994 & Supp. III 1997)).

21 *See* 15 U.S.C. § 78b (1994) (indicating that Congress drafted the Act in part "to insure the maintenance of fair and honest markets"); *see also* Jennifer D. Antolini et al., *Securities Fraud*, 34 AM. CRIM. L. REV. 983, 984 (1997) ("The purpose of [the] Act[ ] is to ensure vigorous market competition by mandating full and fair disclosure of all material information in the marketplace.").

22 *See* 15 U.S.C. § 78b.

23 *See* Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (imposing restrictions on directors, officers, and 10% shareholders from purchasing and selling within a six-month period).

24 *See* H.R. REP. No. 98-355, at 3 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275-76.

25 *See* Painter et al., *supra* note 12, at 160-61 nn.29, 31.

included a "catchall"[26] provision in section 10(b).[27] The original purpose of section 10(b) was not to prohibit insider trading;[28] section 16 fulfilled that function.[29] In fact, section 10(b) and Rule 10b-5 (or any of the federal statutes, rules, or regulations) do not define "insider trading" or "inside information" (or "misappropriation," for that matter).[30] Section 10(b) simply states in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.[31]

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26 Chiarella v. United States, 445 U.S. 222, 234-35 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 206 (1976).

27 *See* Painter et al., *supra* note 12, at 161 ("Section 10(b) . . . allowed the Commission, under the watchful eye of the federal courts, to prohibit 'manipulative or deceptive' conduct as it arose and as law enforcement strategies became available.").

28 *See id.* at 160 ("Although Congress was concerned about insider trading in 1934, it seems unlikely that it specifically envisioned insider trading as coming within the proscriptions of Section 10(b)."); *see also Hochfelder*, 425 U.S. at 202 ("[T]he intended scope of § 10(b) . . . [is not] revealed explicitly in the legislative history of the 1934 Act, which deals primarily with other aspects of the legislation.").

29 *See* Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 56-57 (1980) ("The conventional wisdom is that Congress . . . expressed its concern with insiders' informational advantage by enacting section 16.")

Indeed, legislative history indicates that the purpose of section 10(b) was to serve as a catchall provision:

> In addition to the discretionary and elastic powers conferred on the administrative authority, effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function. These sanctions are found in sections 9, 10 and 16.

S. REP. No. 73-792, at 6 (1934).

30 *See* H.R. REP. No. 100-910, at 7-8 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6044 ("'Insider trading' is not defined in the securities laws, but the term is used broadly to refer to the purchase or sale of securities while in possession of 'material' information (generally, information that would he important to an investor in making a decision to buy or sell a security) that is not available to the general public (that is 'nonpublic')."); Langevoort, *supra* note 10, at 3 (stating that "neither [Rule 10b-5] nor [section 10(b)] expressly prohibits insider trading"); Painter et al., *supra* note 12, at 160 ("The text of Section 10(b) . . . does not even mention insider trading."); Swanson, *supra* note 11, at 1164 ("Insider trading is neither defined nor expressly prohibited by federal regulation.").

31 Securities Exchange Act of 1934 § 10(b); 15 U.S.C. § 78j(b) (1994).

Pursuant to its section 10(b) rule-making authority, the SEC promulgated Rule 10b-5 in 1942[32] to combat securities fraud.[33] Rule 10b-5 states in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud, . . . or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[34]

Despite the lack of insider trading language, the courts have construed section 10(b) and Rule 10b-5 promulgated thereunder as prohibiting specific trading based on material, nonpublic information.[35] Today, section 10(b) and Rule 10b-5 are the Government's primary means of regulating current forms of insider trading.[36]

B. The Fairness Approach

Prior to the Supreme Court's treatment of insider trading in *Chiarella v. United States*,[37] adjudicators and commentators articulated contract notions of fraudulent misrepresentation and the duty of good faith and fair dealing in applying section 10(b) and Rule 10b-5 to insider trading. These contract doctrines typically allow the rescission of agreements between private parties when there is intentional nondisclosure of material information.[38] The pre-*Chiarella* insider trading theories applied these common law principles of face-to-face private agreements to impersonal securities transactions in public markets.

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32 *See* H.R. REP. No. 98-355, at 3 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2276.

33 *See Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967) (statement of Milton Freeman) (indicating Commissioner Sumner Pike's approval of Rule 10b-5: "'Well, . . . we are against fraud, aren't we?'").

34 17 C.F.R. § 240.10b-5 (1998).

35 *See* Antolini et al., *supra* note 21, at 993-94; *see also* Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 4-5, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842) ("The federal courts for almost thirty years . . . have held that trading by corporate insiders in possession of material nonpublic information is . . . in violation of § 10(b) and Rule 10b-5.").

36 Section 10(b) and Rule 10b-5 also have appeared in private securities litigation (between a shareholder and the company whose stock he owns) but with a much narrower scope. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1996) (codified in scattered sections of 15 U.S.C.) (indicating heightened pleading requirements for private Rule 10b-5 plaintiffs); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 754-55 (1975) (holding that only actual purchasers and sellers of securities may bring a private Rule 10b-5 suit).

37 445 U.S. 222 (1980).

38 *See* RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. b (1981).

1. Cady, Roberts: *The Disclose or Abstain Rule*

In *In re Cady, Roberts & Co.*,[39] the SEC first postulated that section 10(b) and Rule 10b-5 prohibited using inside information to trade securities in public markets.[40] According to *Cady, Roberts*, section 10(b) and Rule 10b-5 require a party to a securities transaction to disclose material information if two principal elements exist:

> first, . . . a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent *unfairness* involved where a party takes advantage of such information *knowing it is unavailable* to those with whom he is dealing.[41]

If the party chooses not to disclose, "the alternative is to forego the transaction."[42] This obligation that the SEC articulated in *Cady, Roberts* is now recognized as the "disclose or abstain" rule.[43]

The langnage of *Cady, Roberts*'s disclose or abstain rule is similar to that of *Restatement (Second) of Contracts* § 161(b):

> A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist . . .
>
> . . . .
>
> (b) where he *knows that disclosure of the fact would correct a mistake* of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of *fair dealing*.[44]

In addition to sharing similar langnage regarding fairness and knowledge of the other party's ignorance, *Cady, Roberts* and section 161(b) parallel each other in their treatment of the effect of disclosure. As the SEC indicated in *Cady, Roberts*, "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*."[45] This language reflects section 161(b), which mandates that "one is expected to disclose only such facts as he knows or has reason to know will *influence the other in determining his course of action*."[46]

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39 40 S.E.C. 907 (1961).

40 *See id.* at 911.

41 *Id.* at 912 (footnote omitted) (emphasis added).

42 *Id.* at 911.

43 Chiarella v. United States, 445 U.S. 222, 227 (1980).

44 RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1981) (typeface altered) (emphasis added).

45 40 S.E.C. at 911 (emphasis added).

46 RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. b (1981) (emphasis added).

In *Cady, Roberts*, the SEC construed section 10(b) and Rule 10b-5 broadly. It indicated that section 10(b) and Rule 10b-5 "are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others."[47] In other words, even if nondisclosure of inside information does not constitute fraud, it nonetheless "may be viewed as a . . . practice which *operate*[*s*] as a fraud or deceit upon the purchasers" in violation of Rule 10b-5.[48] Thus, the disclose or abstain rule is based on a policy of fairness to public investors.

2. Texas Gulf Sulphur: *Clarifying the Disclose or Abstain Rule*

In *SEC v. Texas Gulf Sulphur Co.*,[49] the Second Circuit followed the SEC's fairness approach of *Cady, Roberts*, stating that the purpose of section 10(b) and Rule 10b-5 is "to prevent *inequitable and unfair practices* and to insure *fairness* in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges."[50] The Second Circuit further explained:

> The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have *equal access* to the rewards of participation in securities transactions. It was the intent of Congress that all members of the *investing public* should be subject to *identical market risks*,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put at risk may exceed another's capacity or capital.[51]

Based on these policy considerations, the Second Circuit asserted its own version of the *Cady, Roberts* disclose or abstain rule:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.[52]

Texas Gulf Sulphur modifies or clarifies *Cady, Roberts* in several respects. First, the *Texas Gulf Sulphur* rule expands the scope of section 10(b) and Rule 10b-5 to reach *any participant*, not just corporate insiders as

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47 *Cady, Roberts*, 40 S.E.C. at 911.

48 *Id.* at 913 (emphasis added).

49 401 F.2d 833 (2d Cir. 1968) (en banc).

50 *Id.* at 848 (emphasis added).

51 *Id.* at 851-52 (emphasis added). The Second Circuit also stated, "The only regulatory objective is that *access to material information* be enjoyed *equally*. . . ." *Id.* at 849 (emphasis added).

52 *Id.* at 848.

the first prong of *Cady, Roberts* suggests.[53] Second, unlike *Cady, Roberts*, the *Texas Gulf Sulphur* rule extends the disclose or abstain prohibition beyond trades to recommendations based on inside information. Third, *Texas Gulf Sulphur* defines inside information as material if its disclosure is "reasonably certain to have a substantial effect on the market price of the security,"[54] following *Cady, Roberts* and *Restatement (Second) of Contracts* § 161(b).[55] Furthermore, *Texas Gulf Sulphur* indicates that although the insider has no duty "to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions,"[56] he must disclose the "basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders."[57] Again, the Second Circuit's language recalls the common law contract principles of fraudulent misrepresentation. Section 161(b) states:

> A party may . . . reasonably expect the other to take normal steps to inform himself and to draw his own conclusions. If the other is indolent, inexperienced or ignorant, or if his judgment is bad or he lacks access to adequate information, his adversary is not generally expected to compensate for these deficiencies.[58]

3. *A Comparison of the Fairness Theories*

The theories arising from the fairness approach—as Table 1 displays—are consistent with the common law fraudulent misrepresentation principles in *Restatement (Second) of Contracts* § 161(b). All three fairness notions generally agree that deception occurs when the trader fails to disclose information that is both material to the transaction and unknown to his or her counterparts. Each fairness theory, however, differs slightly from the common law doctrine. The *Cady, Roberts* rule generally reaches insiders and thus imposes an obligation to disclose corporate information. The *Texas Gulf Sulphur* rule is more

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53 *See supra* note 41 and accompanying text. While the SEC noted in *Cady, Roberts* that section 10(b) and Rule 10b-5 reach "any person," it nonetheless recognized its task as "identify[ing] those persons who are in a special relationship with a company and privy to its internal affairs." *Cady, Roberts*, 40 S.E.C. at 912.

54 401 F.2d at 848 (quoting Arthur Fleischer, Jr., *Securities Trading and Corporate Information Practices: The Implications of the* Texas Gulf Sulfur *Proceeding*, 51 VA. L. REV. 1271, 1289 (1965) (internal quotation marks omitted)). The Supreme Court later adopted its own materiality test. *See infra* note 317.

The Second Circuit further stated that disclosure of material information must occur "in a manner sufficient to insure its availibility [sic] to the investing public." *Texas Gulf Sulphur*, 401 F.2d at 854.

55 *See supra* notes 45-46 and accompanying text.

56 *Texas Gulf Sulphur*, 401 F.2d at 848.

57 *Id.* at 849.

58 RESTATEMENT (SECOND) OF CONTRACTS § 161 cmt. d (1981).

expansive: it extends liability to anyone, and it imposes an obligation to disclose nonpublic information.

The insider trading theories also deviate from the common law rule in that the trader must disclose the information publicly and not merely to the other parties. This difference exists because securities exchanges involve impersonal transactions, and the transacting parties are not easy to identify, especially in transactions involving prospective buyers.[59] There is some indication that Rule 10b-5 originally sought to protect sellers, but courts and the SEC have extended it to protect buyers as well.[60] According to *Cady, Roberts*:

> There is no valid reason why persons who *purchase* stock from an officer, director or other person having the responsibilities of an "insider" should not have the same protection afforded by disclosure of special information as persons who *sell* stock to them. Whatever distinctions may have existed at common law based on the view that an officer or director may stand in a fiduciary relationship to existing stockholders from whom he purchases but not to members of the public to whom he sells, it is clearly not appropriate to introduce these into the broader anti-fraud concepts embodied in the securities acts.[61]

For the Second Circuit, these antifraud provisions of section 10(b) and Rule 10b-5 should embrace a broad fairness approach rather than a narrower common law fiduciary approach.

Whether it is appropriate to base insider trading law on common law fraudulent misrepresentation doctrine, however, is unclear. This fairness approach may not properly address the insider trading problem. Fraudulent misrepresentation typically applies to a private breach-of-contract action involving a face-to-face transaction with a rescission remedy; insider trading is a statutory, criminal violation involving an impersonal transaction through a public securities exchange.[62] On the other hand, if section 10(b) and Rule 10b-5 "are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient

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59 *See* Goodwin v. Agassiz, 186 N.E. 659, 661 (Mass. 1933) (indicating that it would be difficult for insiders to seek out the other actual party to the transaction for disclosure).

60 *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 913 (1961) ("Although the primary function of Rule 10b-5 was to extend a remedy to a defrauded seller, the courts and this Commission have held that it is also applicable to a defrauded buyer.").

61 *Id.* at 913-14.

62 It is not entirely apparent that application of common law contract principles to insider trading is appropriate. *See Goodwin*, 186 N.E. at 661 (stating that principles applicable to face-to-face transactions are not applicable to "commonly impersonal affairs"); Dooley, *supra* note 29, at 59 (arguing that insider trading does not involve reliance); Langevoort, *supra* note 10, at 7-8 (arguing that although reliance on nondisclosure is apparent in face-to-face transactions, it is less obvious in impersonal market transactions).

TABLE 1
A COMPARISON OF THE FAIRNESS THEORIES

Theory	Deception	Trader's duty	Duty owed to whom?	Reason for duty
Restatement of Contracts § 161(b)	Nondisclosure (fraudulent misrepresentation doctrine)	Disclose material information unknown to other party	Party to the transaction	Duty of good faith and fair dealing
Cady, Roberts (applies to insiders)	Nondisclosure	Disclose material information for a corporate purpose	Market	Fairness considerations
Texas Gulf Sulphur (applies to anyone)	Nondisclosure	Disclose material, nonpublic information	Market	Fairness considerations

to sustain a common law action for fraud and deceit,"[63] then looking to the common law fraudulent misrepresentation doctrine as a basis for insider trading liability may be appropriate.

The SEC and the Second Circuit decided that section 10(b) sustained the fairness approach. As the next Part of this Note reveals, however, the Supreme Court adopted a liability theory based on the notion of fiduciary relationships. The Court rejected a theory based on section 161(b) considerations thus changing the landscape of insider trading jurisprudence.

II
ANALYSIS OF THE DEVELOPMENT OF INSIDER TRADING THEORY

Unlike the SEC and the Second Circuit, the Supreme Court determined that the statutory requirements of section 10(b) do not sustain the fairness approach to insider trading liability. By construing section 10(b) narrowly, the Court excused trading that some had considered illegal. This narrow construction led to proposals of numerous new insider trading theories, which attempt to reach trading that the fairness approach once prohibited. This Part discusses the evolution of insider trading jurisprudence prior to the Supreme Court's decision in *O'Hagan*.

63 *Cady, Roberts*, 40 S.E.C. at 910.

A. *Chiarella*: Rejection of the Fairness Approach

1. *The Classical Theory*

The Supreme Court first addressed section 10(b)'s role in insider trading liability in *Chiarella v. United States*.[64] In *Chiarella*, the defendant, a financial printer employee, received documents of corporate takeover bids from the client corporation.[65] The defendant deduced the encoded names of target companies on the documents and purchased their stock.[66] The Supreme Court determined that the issue "concerns the legal effect of the petitioner's silence" and whether a pretrading duty to disclose had arisen.[67] The Court held that the federal securities laws do not reach the defendant's conduct because "a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."[68] It rejected the fairness approach of *Cady, Roberts* and *Texas Gulf Sulphur*, noting that "neither the Congress nor the Commission ever has adopted a parity-of-information rule."[69]

The Court then laid the framework for what later became the "classical theory" of insider trading.[70] It adopted a narrow construction of the deception requirement of section 10(b). The Court asserted that what section 10(b) catches "must be *fraud*" and that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak."[71] It articulated this section 10(b) obligation by quoting the fraudulent nondisclosure doctrine of *Restatement (Second) of Torts* § 551(2)(a): "[T]he duty to disclose arises when one party has information 'that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them.'"[72] Thus, this more limited liability theory derives from an insider's fiduciary relationship with the transacting shareholders.[73] The Court noted that this application of fraudulent

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64 445 U.S. 222 (1980).

65 *See id.* at 224.

66 *See id.*

67 *Id.* at 226.

68 *Id.* at 235.

69 *Id.* at 233. According to the Court:

> We cannot affirm petitioner's conviction without recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information. Formulation of such a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, should not be undertaken absent some explicit evidence of congressional intent.

Id. (citation omitted).

70 United States v. O'Hagan, 521 U.S. 642, 651-52 (1997).

71 *Chiarella*, 445 U.S. at 235 (emphasis added).

72 *Id.* at 228 (second alteration in original) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).

73 *See infra* notes 97-100 and accompanying text.

nondisclosure prevents the breach of fiduciary duty because it "guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[74] The classical theory could not reach the defendant in *Chiarella* because he was a "complete stranger" to the shareholders and thus owed no duty to disclose.[75]

2. *Chief Justice Burger's and Justice Stevens's Theories of Misappropriation*

In *Chiarella*, the Government argued for an alternative theory of liability, suggesting that the defendant had committed fraud against both (1) the client corporation whose information he had obtained through his employment and (2) the target shareholders with whom he had traded securities upon that information.[76] The Court declined to address the Government's theory because the Government did not present it to the jury.[77] The trial judge instructed that the jury could convict on a violation of section 10(b) if it merely found that the defendant had failed to disclose material, nonpublic information in connection with securities trading.[78] Consequently, the jury only decided whether the defendant had owed a duty to the transacting shareholders, but not whether he had owed a duty to anyone else.[79]

In his dissent, Chief Justice Burger disagreed with the majority's narrow scope of the section 10(b) and Rule 10b-5 obligation, arguing "that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[80] He asserted that the fraudulent nondisclosure doctrine should include a disclosure requirement "when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means."[81] To support his reasoning, Chief Justice Burger cited Professor Keeton's proposal that "[a]ny time information is

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74 *Chiarella*, 445 U.S. at 230.

75 *Id.* at 232-33 ("He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence. He was, in fact, a complete stranger who dealt with the sellers only through impersonal market transactions.").

76 *See id.* at 235-36.

77 *See id.* at 236-37 ("Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of § 10(b)." (citations omitted)).

78 *See id.* at 236.

79 *See id.*

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

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

acquired by an illegal act it would seem that there should be a duty to disclose that information."[82]

While the Chief Justice recognized a duty to the shareholders under Rule 10b-5, Justice Stevens, in his concurrence, recognized a duty to the employer and to the client corporation—the sources of information—independent of the securities laws.[83] Justice Stevens argned that the defendant "unquestionably owed [a duty of silence] to his employer and his employer's customers," but he queried as to whether a breach of such duty "could give rise to criminal liability under rule 10b-5."[84] This "duty of silence"[85] is similar to the duty of loyalty that *Restatement (Second) of Agency* § 395 articulates:

> Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is matter of general knowledge.[86]

The defendant's breach of this fiduciary duty may have violated section 10(b) and Rule 10b-5, according to Justice Stevens, because of the "fraud or deceit" the defendant perpetrated on the sources of information "in connection with" securities trading.[87] Chief Justice Burger may have given the theory its name, but the lower courts endorsed Justice Stevens's fraud-on-the-source theory[88] and subsequently coined it the misappropriation theory.[89]

3. *The Access to Information Theory*

In dissent, Justice Blackmun argued that the Court could find a section 10(b) violation without resorting to a misappropriation the-

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82 *Id.* (Burger, C.J., dissenting) (quoting W. Page Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25-26 (1936) (typeface altered)).

83 *See id.* at 237-38 (Stevens, J., concurring).

84 *Id.* at 238 (Stevens, J., concurring).

85 *Id.* (Stevens, J., concurring).

86 RESTATEMENT (SECOND) OF AGENCY § 395 (1958).

87 *See Chiarella*, 445 U.S. at 238 (Stevens, J., concurring). On the other hand, Justice Stevens noted, this breach may not violate section 10(b) because the sources of information were neither purchasers nor sellers of securities. *See id.* Thus, the sources whom the defendant arguably defrauded would not be able to recover in a private action under Rule 10b-5. *See supra* note 36 and accompanying text.

88 It is important to note that while Justice Stevens suggested that misappropriation may violate Rule 10b-5, he did not assert that it necessarily did. Because *O'Hagan* eventually takes the position that misappropriation indeed constitutes a securities law violation, however, this Note refers to this position as Justice Stevens's theory.

89 *See infra* Part II.D.

ory.[90] In response to Chief Justice Burger's and Justice Stevens's misappropriation theories, Justice Blackmun stated that he would find the defendant's conduct illegal "even if he had obtained the blessing of his employer's principals."[91] He contended that such trading "*with or without such approval*, lies close to the heart of what the securities laws are intended to prohibit."[92] Justice Blackmun would have held "that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities."[93] His dissent echoes Professor Victor Brudney's proposed "access to information" theory,[94] to which Justice Blackmun cites.[95] Under Professor Brudney's access to information theory, section 10(b) prohibits an informed investor from trading on material information that he knows is not legally attainable by his trading counterparts.[96] Professor Brudney's theory is not dissimilar to the fairness approaches of *Cady, Roberts* and *Texas Gulf Sulphur*.[97]

4. *Rule 14e-3(a)*

Four months after the Supreme Court decided *Chiarella*, the SEC promulgated Rule 14e-3(a)[98] pursuant to section 14(e) of the Securities Exchange Act.[99] Rule 14e-3(a) prohibits securities trading on ma-

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90 *See Chiarella*, 445 U.S. at 245 (Blackmun, J., dissenting).

91 *Id.* at 246 (Blackmun, J., dissenting).

92 *Id.* (Blackmun, J., dissenting) (emphasis added). Interestingly, Justice Blackmun's dissent in *Chiarella* foreshadows Justice Thomas's dissent in *O'Hagan* 17 years later. *See infra* notes 248-51 and accompanying text.

93 *Chiarella*, 445 U.S. at 251 (Blackmun, J., dissenting).

94 *See* Victor Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 353-67 (1979). Professor Brudney's theory in turn is reminiscent of *Texas Gulf Sulphur*, which states that Rule 10b-5 "is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively *equal access* to material information." SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (emphasis added).

95 *See Chiarella*, 445 U.S. at 251-52 (Blackmun, J., dissenting).

96 *See* Brudney, *supra* note 94, at 354-55.

97 The equal access approach has not attracted the same judicial attention as the misappropriation theory. "[N]evertheless, it has been subject to some academic criticism. Law and economics scholars have argued that access can always be purchased in some way; one could, for example, devote one's life to becoming a corporate director and thus have the same legal access to corporate information." Dalley, *supra* note 12, at 1334.

98 17 C.F.R. § 240.14e-3(a) (1998). *See generally* ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS 860-61 (6th ed. 1998) (describing the history and scope of Rule 14e-3(a)).

99 Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1994)). Section 14(e) states in pertinent part:

> It shall be unlawful for any person . . . to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer . . . . The [SEC] shall, for the purposes of this subsection, by rules and

terial, nonpublic information regarding a tender offer,[100] regardless of whether the trader breaches a fiduciary duty.[101] Thus, the rule would reach any future conduct similar to that in *Chiarella.* The SEC promulgated Rule 14e-3(a) to make it easier to establish a prima facie case against misappropriators whose fiduciary relationship or duty is difficult to prove.[102] Some suggest that the SEC wished to prohibit conduct even when there is *no* breach of fiduciary duty.[103] Thus, at least in the tender offer context, insider trading law returned to the pre-*Chiarella* fairness approach by criminalizing all trading on material, nonpublic information.

5. *A Comparison of the Theories Surrounding* Chiarella

The Supreme Court's decision in *Chiarella* generated numerous insider trading theories and an SEC rule, as Table 2 depicts. The bases of these insider trading theories range from fraudulent misrepresentation principles of *Restatement (Second) of Contracts* § 161(b) to the fraudulent nondisclosure doctrine of *Restatement (Second) of Torts* § 551(2)(a) to duty of loyalty principles of the *Restatement (Second) of Agency* § 395. At one end of this spectrum lies the SEC-promulgated

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> regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. § 78n(e) (1994). Pursuant to its rule-making authority, the SEC promulgated Rule 14e-3(a), which states:

> If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:
>
> (1) The offering person,
>
> (2) The issuer of the securities sought or to be sought by such tender offer, or
>
> (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or . . . any option or right to obtain or to dispose of any of the foregoing securities, uuless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

17 C.F.R. § 240.14e-3(a).

100 *See id.*

101 *See, e.g.,* United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (en banc) (asserting that Rule 14e-3(a) "creates a duty . . . to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty").

102 *See, e.g.,* SEC v. Peters, 978 F.2d 1162, 1167 (10th Cir. 1992) (indicating that in a tender offer context, a breach of fiduciary duty is "almost impossible to prove").

103 *See, e.g.,* United States v. O'Hagan, 521 U.S. 642, 695 (1997) (Thomas, J., concurring in judgment in part and dissenting in part) (stating that this wish "exceeds the scope of the [SEC]'s authority").

Rule 14e-3(a); at the other end is Justice Stevens's misappropriation theory.[104]

Rule 14e-3(a), applicable only in the context of tender offers, appears to derive from the pre-*Chiarella* fairness approach.[105] Consequently, it probably finds deception in the nondisclosure of material, nonpublic information. Furthermore, the mere possession of this material, nonpublic information triggers the trader's duty to disclose this information to the market. The access to information theory, which Justice Blackmun and Professor Brudney endorse, states that deception occurs when the trader fails to disclose unattainable material information. The trader's duty to disclose arises because the public does not have access to this information. The classical theory also finds deception in the nondisclosure of material, nonpublic information. The trader's duty to disclose to the market arises because the trader is in a fiduciary or similar relationship with the uninformed shareholders.[106] Chief Justice Burger's theory finds deception in the nondisclosure of nonpublic, misappropriated information. The trader's duty to disclose to the market arises because he possesses misappropriated information. Justice Stevens's theory does not discuss liability in the same terms as the aforementioned insider trading theories. Instead of a duty to disclose information to the market, the trader or potential trader has a fiduciary duty to refrain from misappropriation of the principal's information through securities trading.

6. *State of the Law After* Chiarella

The classical theory, the law after *Chiarella*, derives from *Restatement (Second) of Torts* § 551(2)(a). Section 551(2)(a) doctrine in turn derives from fiduciary relationships, and its application to insider trading encounters several problems. The Supreme Court seemingly re-

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104 One commentator pointed out that from a different perspective these opposite poles may not be so dissimilar:

> To the extent that the only people who have unequal access are people who receive information that is protected legally (and so cannot be acquired by others at any price), the access theory will cover the same cases covered by the misappropriation theory, except to the extent that a trader with permission from her employer is covered by the equal access rule but not the misappropriation theory. Additionally, because the equal access rule is based on the public's *lawful* access to the information in question, it is closely related to property-based rules . . . .

Dalley, *supra* note 12, at 1334-35 (footnote omitted).

105 *See supra* Part I.B.

106 *See* Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 104 (1984). "The basis of the rule that a fiduciary duty creates an obligation of full disclosure appears to be that, at least in face-to-face dealings, one who has reposed trust and confidence in another is entitled to assume the nonexistence of material facts that the other does not reveal." *Id.*

TABLE 2
A COMPARISON OF INSIDER TRADING THEORIES AFTER *Chiarella*

Theory	Deception	Trader's duty	Duty owed to whom?	Reason for duty
Rule 14e-3(a) (applicable only in tender offer contexts)	Nondisclosure under *Restatement of Contracts* § 161(b)	Disclose material, nonpublic information	Market	Possession of material, nonpublic information
Blackmun's and Brudney's access theory	Nondisclosure under *Restatement of Contracts* § 161(b)	Disclose unattainable material information	Market	Fairness: Counterparty has no access to information
Classical theory	Nondisclosure under *Restatement of Torts* § 551(2)(a)	Disclose material, nonpublic information	Market	Fiduciaries in a transaction
Burger's theory	Nondisclosure under Keeton's proposal	Disclose nonpublic, misappropriated information	Market	Trading on misappropriated information
Stevens's misappropriation theory	No deception [Breach of fiduciary duty under *Restatement of Agency* § 395]	Disclosure insufficient; must obtain consent	Principal(s)—Source(s) of information	Duty of loyalty

solved one of these problems; the others are dormant, but they reappear in the misappropriation context.[107]

One implicit clarification that *Chiarella* makes is that the classical theory embraces the *Cady, Roberts* notion that section 10(b) protects both buyers and sellers of securities. Presumably, a liability theory based on section 551(2)(a) generally protects only sellers because they are shareholders and thus fiduciaries.[108] Buyers, unless they are already shareholders, are merely *prospective* shareholders and thus are not typically considered fiduciaries of the corporate insider.[109] In a footnote, however, *Chiarella* indicates that the classical theory protects buyers and sellers alike, quoting Judge Learned Hand's remarks cited in *Cady, Roberts*:

> [T]he director or officer assumed a fiduciary relation to the buyer by the very sale; for it would be a sorry distinction to allow him to use the advantage of his position to induces the buyer into the posi-

107 *See infra* Part IV.B.2.

108 *See* Pritchard, *supra* note 12, at 26 (stating that the common law doctrine "generally extends only to current shareholders," not "to prospective shareholders who . . . purchase their shares for the first time"). "The classical theory fails to account adequately for this inconsistency with the common law." *Id.*

109 *See id.*

> tion of a beneficiary although he was forbidden to do so once the buyer had become one.[110]

Chiarella's "selective" reliance on the common law § 551(2)(a) doctrine has been criticized.[111] As one commentator noted, "The distinction between the insider who sells and the insider who buys may well be a 'sorry' one, but it is a natural consequence of a theory which premises liability on a preexisting relationship between the trading parties."[112]

Another consequence of the classical theory's focus on a fiduciary relationship is that the nebulous definition of "fiduciary" creates several potential problems for insider trading law. First, federal law regulates securities transactions, but state law defines fiduciary relationships, and thus, the classical theory may not apply uniformly.[113] For example, the majority view in early common law stated that corporate officers were not fiduciaries of their shareholders.[114] Second, if what constitutes a "fiduciary" is unclear, what constitutes a "similar relation of trust and confidence"[115] is even less clear. Third, enforcement of criminal liability with an imprecise rule raises constitutional concerns.[116] These problems are not so serious in the classical context because *Chiarella* reaches only company insiders. These problems indeed emerge, however, when the courts attempt to extend liability to outsiders.

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110 Chiarella v. United States, 445 U.S. 222, 227 n.8 (1980); 40 S.E.C. 907, 914 n.23 (1961) (quoting Gratz v. Claughton, 187 F.2d 46, 49 (2d Cir. 1951) (opinion of Hand, J.) (internal quotation marks omitted)).

111 *See* Pritchard, *supra* note 12, at 26-27.

112 Aldave, *supra* note 106, at 108.

113 *See infra* notes 308-10 and accompanying text.

114 *See* Dalley *supra* note 12, at 1298-1302. Another commentator noted that the law did not always regard insiders as fiduciaries of their shareholders:

> Indeed, the majority common law rule was that directors and other insiders owed a fiduciary duty to their corporation, but not to its shareholders, and that such insiders could trade in the corporation's securities without full disclosure. Only a minority of jurisdictions insisted that an insider owed a fiduciary duty to their corporation and its shareholders, and required the insider to disclose all material facts in connection with his purchases of the company's securities. The Supreme Court, in an early case, adopted the intermediate position that "special facts" could create a duty of disclosure.

Aldave, *supra* note 106, at 104-05 (footnotes omitted). The implied shareholder reliance on the fiduciary insider, however, may by illusory: "In the ordinary case, . . . it is probably entirely fictional to say that a shareholder reposes trust and confidence in a director, officer, or controlling shareholder of a corporation." *Id.* at 105.

115 Chiarella v. United States, 445 U.S. 222, 228 (1980) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (internal quotation marks omitted)).

116 *See* Grayned v. Rockford, 408 U.S. 104, 108 (1972) ("It is a basic principle of due process that an enactment is void for vagueness if its prohibitions are not clearly defined."); *see also* Buckley v. Valeo, 424 U.S. 1, 77 (1976) ("Due process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal. . . .").

B. *Dirks*: "Tippee" Liability Theories

1. *The SEC's and the Court's Theories*

Because the Supreme Court narrowly construed section 10(b) in *Chiarella*, the scope of the classical theory did not reach the defendant in *Dirks v. SEC*.[117] In *Dirks*, the defendant, an investment analyst, was not a corporate insider. He thus owed no fiduciary duty to the shareholders, even though he received nonpublic, corporate information from insiders in the course of his employment.[118] The defendant alerted investor clients about the possibility that a particular corporation's fraudulent practices had resulted in an overvalued stock price.[119] The stock price soon fell drastically.[120] The SEC brought section 10(b) and Rule 10b-5 charges against the defendant under a tippee liability theory.[121] The SEC's tippee liability theory stated that when a tippee knowingly receives material, nonpublic information from an insider, the tippee inherits the insider's fiduciary duty to disclose before trading.[122]

The Supreme Court did not accept the SEC's theory, stating that it is similar to the fairness approach that the Court had rejected in *Chiarella*.[123] The Court reaffirmed *Chiarella*'s assertion that "[a] duty [to disclose] arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."[124] It also recognized that the SEC's theory may impose an unreasonable restriction on market analysts: "Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."[125]

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117 463 U.S. 646 (1983).

118 *See id.* at 648-49.

119 *See id.* at 649-50.

120 *See id.* at 650.

121 *See id.* at 650-51.

122 *See id.* at 655-56. The SEC stated that "[w]here 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading." *In re* Dirks, Securities Exchange Act of 1934 Release No. 17480 (quoting *Chiarella*, 445 U.S. at 230 n.12 (footnote omitted)), *reprinted in* 21 S.E.C. Docket 1401, 1407 (1981).

123 *See Dirks*, 463 U.S. at 656.

124 *Id.* at 657-68 (quoting *Chiarella*, 445 U.S. at 231-32, n.14 (internal quotation marks omitted) (alterations in original)).

125 *Id.* at 658. The Court continued:

> It is commonplace for analysts to ferret out and analyze information, and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally

In rejecting the SEC's tippee theory, the Court nonetheless realized that "[t]he need for a ban on some tippee trading is clear."[126] The Court reasoned, "Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain."[127] The Court then developed its own tippee liability theory:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[128]

In distinguishing its tippee theory from the SEC's, the Court explained that "some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*."[129] The Court also indicated that the insider breaches a fiduciary duty only when he benefits at the expense of the shareholders.[130] Thus, the tippee theory also has a personal benefit test. Under this test, the Court determines "whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."[131]

In footnote fourteen, the Court also suggested that section 10(b) liability may reach tippees even when the tipping insider commits no fiduciary breach.[132] When the insider conveys inside information to independent contractors who hold a fiduciary duty to the corporation, these "temporary insiders" assume section 10(b) obligations.[133] The Court reasoned:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer,

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> may be the basis for judgments as to the market worth of a corporation's securities.

Id. at 658-59 (citation and footnote omitted); *see also id.* at 658 n.18 ("The SEC's rule—applicable without regard to any breach by an insider—could have serious ramifications on reporting by analysts of investment views.").

126 *Id.* at 659.

127 *Id.*

128 *Id.* at 660.

129 *Id.*

130 *See id.* at 661-64.

131 *Id.* at 662. Whether the tipper receives a benefit depends upon an examination of the objective facts and circumstances. *See id.* at 663-64.

132 *See id.* at 655 n.14.

133 Weiss, *supra* note 12, at 415.

> or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather 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.[134]

The last clause of this passage from *Dirks* is reminiscent of the first element of the *Cady, Roberts* rule: "[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."[135] Although the Court suggested in *Chiarella* and *Dirks* that the classical and tippee liability theories are consistent with *Cady, Roberts*, these Supreme Court opinions reject the basis for the SEC decision.[136] Thus, there is a noticeable tension as *Dirks* attempts to reconcile its tippee liability theory with the classical theory and the theory of *Cady, Roberts*.

2. *A Comparison of Tippee Theories*

In *Dirks*, the theory that the SEC proposed, the theory that the Court eventnally adopted, and the language of footnote fourteen each would impose liability if the trading tippee fails to disclose material, nonpublic information to the market. The theories differ, however, in how those duties to disclose arise. As Table 3 indicates, the SEC theory imposes a section 10(b) obligation if the tippee knows that the tipper is a fiduciary of the shareholders—if the tipper is an insider. Under *Dirks*, the tippee only has this obligation if he knows that the insider, in disclosing information to him, breached a fiduciary duty to the shareholders. Footnote fourteen of *Dirks* indicates that if the tipper does not breach a fiduciary duty, the tippee still may have this obligation if he himself is in a "special confidential relationship" to the tipper or his company.

3. Dirks *in Light of* Chiarella

From *Dirks*, two strange notions emerge: (1) the element of fiduciary breach with respect to insider trading and (2) the concern for legitimate conveyance or use of confidential information. The language of section 10(b) and Rule 10b-5 does not mention the words "fiduciary" or "breach," nor does it discuss the conveyance or use of confidential information. Although *Chiarella* merely alludes to those ideas, *Dirks* centralizes them in insider trading theory.

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134 *Dirks*, 463 U.S. at 655 n.14.

135 *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961).

136 *See Dirks*, 463 U.S. at 653-54; *Chiarella*, 445 U.S. at 226-27 & n.8.

TABLE 3
A COMPARISON OF TIPPEE THEORIES IN *Dirks*

Theory	Deception	Trader's duty	Duty owed to whom?	Reason for duty
Proposed SEC theory	Nondisclosure based on *Restatement of Torts* § 551(2)(a)	Disclose material, nonpublic information	Market	Knowledge that tipper is a fiduciary of shareholders
Dirks theory	Nondisclosure	Disclose material, nonpublic information	Market	Knowledge of tipper's fiduciary breach in tipping
Dirks footnote 14	Nondisclosure	Disclose material, nonpublic information	Market	Tippee is a fiduciary of the tipper's company

In *Chiarella*, the Supreme Court relied on *Restatement (Second) of Torts* § 551(2)(a),[137] which states that nondisclosure of material facts in a transaction between fiduciaries constitutes fraud.[138] To suggest that the *Chiarella* Court based its holding on a breach of fiduciary duty, however, is misleading. Rather, the *Chiarella* Court concluded that section 10(b) only reaches fraud, that fraud only can arise in insider trading if there is an unlawful nondisclosure of material facts, that unlawful nondisclosure arises only if there is a duty to disclose, and that a duty to disclose arises in a business transaction between fiduciaries.[139] There is a distinction between a breach of fiduciary duty and fraud. A breach of fiduciary duty occurs when an insider benefits at the expense of the company's shareholders. Fraud under section 551(2)(a) occurs when the insider enters into a transaction with a shareholder, and despite their fiduciary relationship, the insider fails to disclose material information. Confusion may arise because classical insider trading constitutes both a breach of fiduciary duty and a fraud under section 551(2)(a).[140]

Indeed, the *Dirks* Court inaccurately embraced the notion of a breach of fiduciary duty rather than the notion of section 551(2)(a) nondisclosure between transacting fiduciaries. The Court then extended this fiduciary obligation to a nontransacting party—the tippee. Under the *Dirks* tippee theory, a tippee may not trade on his tip if he knows that the tipper-insider breached a fiduciary duty to the share-

137 *See supra* note 72 and accompanying text.

138 *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976).

139 *See supra* notes 72-74 and accompanying text.

140 In other words, the section 551(2)(a) duty to disclose also ensures that the insider does not breach his fiduciary responsibility to the shareholders. *See supra* text accompanying note 74.

holders.[141] However, the Court failed to explain adequately how a nonfiduciary tippee inherits a "derivative" fiduciary duty to the shareholders from the tipper's breach.[142] It merely imposed on the tippee the strange duty of disclosing to the shareholders inside information that belongs not to them or to the tipping insider but to the corporate principal.[143]

Had the *Dirks* Court instead adopted the proposed SEC theory, which embraces *Chiarella*'s section 551(2)(a) perspective, the Court would still lack a solid legal framework to reach tippee trading. The section 551(2)(a) characterization of this conduct is that the tipper engages in insider trading through a "straw," and "no man should be permitted to do indirectly what he would be forbidden to do directly."[144] This reasoning indicates that the proposed SEC approach imposes liability on the tipper, not on the tippee who actually trades.[145] Thus, it is questionable whether the Court could satisfacto-

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141 *See supra* note 128 and accompanying text. The tipper's breach consists of (1) a tip conveying material, nonpublic information, (2) a tippee's trading on the tip, which injures the shareholders, and (3) the insider's receiving a benefit as a result of the tip. *See supra* text accompanying notes 126-31.

It is questionable whether the personal benefit test is necessary. First, that an insider receives a benefit may be difficult to prove, especially if that benefit is intangible or if the insider received it in the past or will receive it in the future. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 676 n.13 (1983) (Blackmun, J., dissenting) (arguing that the defendant received a benefit of "enhanced reputation"). Second, the fact that the information an insider tips may yield substantial profits is enough to presume that he has received some benefit. *See id.* Third, whether a section 10(b) violation has occurred should not hinge on whether the insider has received a benefit. *See, e.g.*, Weiss, *supra* note 12, at 435 ("[W]hether the tipper receives a personal benefit has no clear relationship to the notion of deceit."); Betsy Palmer Collins, *Recent Decision,* Dirks v. SEC*: Tipping Congress Toward the Federalization of Corporation Law?*, 36 ALA. L. REV. 297, 300, 319 (1984) ("This 'personal benefit' test means that it may be possible to breach a state fiduciary duty and yet not be liable under rule 10b-5."). Fourth, the shareholder suffers injury from the tippee's trading whether or not the tipping insider receives a benefit or not. *See Dirks*, 463 U.S. at 673-74 (Blackmun, J., dissenting).

142 *See* Aldave, *supra* note 106, at 109 ("Precisely how a breach by the insider creates the requisite fiduciary duty on the part of the tippee is unclear."); Pritchard, *supra* note 12, at 27 ("[T]ransformation of the tipper's breach of his duty of confidentiality owed to the corporation into a breach by the tippee of a duty of disclosure to shareholders is hard[ ] to accept.").

The only relationship that insider trading law recognized after *Chiarella* was the fiduciary relationship between the insider and the shareholder. Because, under the *Dirks* liability theory, it is the *insider* who benefits at the expense of the shareholder, it is hard to see how the tippee is liable if he has no obligation to the shareholder.

143 *See* Dooley, *supra* note 29, at 32 ("The corporate principal owns the information and may withhold it so long as withholding serves a valid corporate purpose.").

144 Bird v. Holbrook, 130 Eng. Rep. 911, 917 (C.P. 1828) (opinion of Burrough, J.).

145 Whether tipping without tippee trading constitutes a section 10(b) violation is questionable. The Second Circuit in *Texas Gulf Sulphur* construed section 10(b) as prohibiting insiders from recommending stocks. *See* Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (en banc). Disclosure alone, however, arguably affects the market only when it dissuades a would-be investor from trading. Policing mere disclosure of inside information is problematic because it is difficult, first, to identify would-be traders and then to deter-

rily reach the tippee given the existing framework of insider trading law.

Not only did the *Dirks* Court fail to present a clear theory to prohibit tippee trading,[146] it also aided the acceptance of the misappropriation theory by focusing on the illegitimate communication of information in breach of fiduciary duty. The disclosure of confidential corporate information (regardless of the benefit to the insider or injury to the shareholder) is thought of more as a breach of a duty owed to the corporation rather than the shareholders.[147] This characterization of tipping as a breach of fiduciary duty to the source of the information is the essence of the misappropriation theory.

C. *Carpenter*: Mail and Wire Fraud in Insider Trading

1. *The Mail and Wire Fraud Statutes and Insider Trading*

In *Carpenter v. United States*,[148] the Court had another opportunity to expand insider trading liability under section 10(b). In *Carpenter*, a journalist and several investors entered into a trading scheme designed to exploit the journalist's receipt of nonpublic information.[149] The journalist regularly interviewed corporate executives for his *Wall Street Journal* column, which discussed positive and negative information about selected stocks.[150] Due to the nature of the column's information, it had the potential of affecting the market value of any stocks that it discussed.[151] In several instances prior to the publication of his column, the journalist conveyed this information to in-

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mine from whom they received the tip. *See* Collins, *supra* note 141, at 300 ("At one point during extensive deliberations, Congress considered a bill that would have regulated the tipping of nonpublic information by insiders. The legislators deleted this provision from the 1934 Act, however, apparently because they thought it to be unenforceable."). Although a would-be investor benefits from receiving tips, refraining from trading seems not as egregious as buying when one was about to sell, selling short when one was about to buy, or otherwise actively exploiting this informational advantage.

146 *See* Weiss, *supra* note 12, at 415 (observing that "*Dirks* . . . was, in doctrinal terms, even more enigmatic than *Chiarella*" (footnote omitted)).

147 *See* Pritchard, *supra* note 12, at 27; Weiss, *supra* note 12, at 416. After all, the confidential information belongs to the corporation. *See supra* note 143 and accompanying text.

The rule that the *Dirks* court expressed in footnote 14 indicates that hired accountants, lawyers, and consultants who receive corporate information legitimately *may* become fiduciaries of the shareholders. But these hired tippees are almost certainly fiduciaries of the corporation. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 (1998) (indicating that lawyers may disclose confidential information received from the client organization only to "duly authorized constituents"). Thus, both insiders and "temporary insiders" probably have a duty to the corporation to use confidential information for the benefit of the corporation. *See, e.g.*, RESTATEMENT (SECOND) OF AGENCY § 395 (1998).

148 484 U.S. 19 (1987).

149 *See id.* at 23.

150 *See id.* at 22.

151 *See id.* at 22-23.

vestors, who then traded securities accordingly.[152] While none of the columns at issue contained information that the firms deemed confidential, the *Wall Street Journal* considered confidential all information that the journalist acquired prior to publication.[153] The Government charged the defendants with violating section 10(b) and Rule 10b-5, as well as the federal mail and wire fraud statutes.[154] The district court[155] and the Second Circuit[156] determined that the defendants had violated section 10(b) under the misappropriation theory. The Supreme Court divided four-to-four on the question of whether the defendants had incurred section 10(b) liability when they victimized the *Wall Street Journal*—a party that was indifferent toward the transactions at issue.[157] Thus, the Court did not adopt the misappropriation theory when it affirmed the section 10(b) conviction.[158]

The Supreme Court, however, unanimously affirmed the mail and wire fraud convictions under 18 U.S.C. §§ 1341 and 1343.[159] According to the Court, the reporter's information constituted property for the purposes of the statutes, and "[t]he [*Journal*] had a property right in keeping confidential and making exclusive use" of this information.[160] The Court construed the phrase "to defraud" in the mail fraud statute as "wronging one in his property rights by dishonest

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152 *See id.* at 23.

153 *See id.* at 22-23.

154 *See id.* at 20-21.

155 *See* United States v. Winans, 612 F. Supp. 827, 849-50 (S.D.N.Y. 1985), *aff'd in part and rev'd in part sub nom.* United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

156 *See Carpenter*, 791 F.2d at 1034.

157 *See Carpenter*, 484 U.S. at 24 ("[T]he newspaper [was] the only alleged victim of fraud and ha[d] no interest in the securities traded." (internal quotation marks omitted)).

158 *See id.*

159 *See id.* at 25-28. In pertinent part, section 1341 states:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises . . . places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service . . . or takes or receives therefrom . . . shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

18 U.S.C. § 1341 (1994). In pertinent part, section 1343 states:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined . . . not more than $1,000,000 or imprisoned not more than 30 years, or both.

18 U.S.C. § 1343 (1994).

160 *Carpenter*, 484 U.S. at 26.

methods or schemes."[161] The Court also applied this reading to language in the wire fraud statute because the language is the same in both statutes.[162] Consequently, it held that the defendants' conspiracy had defrauded the *Journal* of the right to exclusive use of its property.[163] Quoting *Grin v. Shine*,[164] the Court asserted that such fraud is akin to "embezzlement, which is 'the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.'"[165]

In support of the notion of information property rights, the Court quoted *Diamond v. Oreamuno*:[166]

> It is well established, as a general proposition, that a person who acquires special knowledge or information by virtue of a confidential or fiduciary relationship with another is not free to exploit that knowledge or information for his own personal benefit but must account to his principal for any profits derived therefrom.[167]

Restatement (Second) of Agency § 388 displays similar language, which provides that "[u]nless otherwise agreed, an agent who makes a profit in connection with transaction conducted by him on behalf of the principal is under a duty to give such profit to the principal."[168]

2. *The Rules of Liability in* Carpenter

The rules of liability discussed in *Carpenter*—as Table 4 displays—are similar to Justice Stevens's theory of misappropriation, but are significantly different from the other prior theories. While the classical, tippee, and fairness theories govern transactions, the rules discussed in *Carpenter* govern principal-agent relationships. Under the *Grin* rule of fraud, an agent's embezzlement of the principal's property constitutes a fraudulent deprivation of the use of a good. This conversion of property is unlawful unless the agent obtains the principal's permission. Under the *Carpenter* rule, an analogous fraud occurs when an agent profits from entrusted confidential information, thereby depriving the principal of exclusive use of a good. Again, the agent only may use the information for personal benefit if he obtains the principal's permission. Under the rule articulated in *Restatement (Second) of*

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161 *Id.* at 27 (quoting McNally v. United States, 483 U.S. 350, 358 (1987) (quoting Hammerschmidt v. United States, 265 U.S. 182, 188 (1924) (internal quotation marks omitted))).

162 *See id.* at 25 n.6.

163 *See id.* at 28.

164 187 U.S. 181 (1902).

165 *Carpenter*, 484 U.S. at 27 (quoting *Grin*, 187 U.S. at 189 (second internal quotation marks omitted)).

166 248 N.E.2d 910 (N.Y. 1969).

167 *Carpenter*, 484 U.S. at 27-28 (quoting *Diamond*, 248 N.E.2d at 912 (internal quotation marks omitted)).

168 RESTATEMENT (SECOND) OF AGENCY § 388 (1958).

Agency § 388, however, there is no specific provision against fraud or deception, just one that addresses the breach of fiduciary duty when an agent fails to give profits from a transaction that the agent conducted on behalf of the principal. The agent may keep the profits if he obtains the principal's permission.

TABLE 4
A COMPARISON OF LIABILITY RULES IN *Carpenter*

Rule	Deception	Duty	Duty owed to whom?	Reason for duty
Rule of fraud in *Grin*	Fraudulent deprivatiou of use of good	Obtain consent [Disclosure is insufficient]	Principal(s)	Deprivation of good constitutes embezzlement or fraud
Rule of fraud in *Carpenter*	Deprivation of *exclusive* use of information	Obtain consent [Disclosure is insufficient]	Principal(s)—Source(s) of information	Deprivation of *exclusive* use of information is like embezzlement or fraud
Restatement (Second) of Agency § 388	None [Agent profits in transaction conducted on behalf of principal(s)]	Obtain consent or account for profits [Disclosure is insufficient]	Principal(s)	Agent owes principal(s) a duty of loyalty

3. *The Species of Fraud in* Carpenter

Carpenter's determination that an agent's appropriation of the principal's information constitutes fraud is questionable. First, the *Diamond* court did not mention "fraud" in the principal-agent context,[169] and the *Restatement (Second) of Agency* only discusses the breach of a duty of loyalty. Whether a breach of a duty of loyalty constitutes fraudulent conduct is unclear. Second, the Court's analogy of appropriation of information in *Carpenter* to embezzlement in *Grin* is a poor fit. The act of embezzling denies the principal's *complete* use of its property, causing obvious injury to the principal. On the other hand, information appropriation denies only the principal's *exclusive* use of this property, and thus, injury to the principal is less apparent.[170]

Although *Carpenter* did not contribute directly to the expansion of securities law to insider trading, it is significant in other respects. First, it demonstrates that the *Dirks* tippee liability theory is limited. Had the *Dirks* duty-oriented tippee theory instead resembled the proposed SEC theory, *Carpenter* may have been an easier case. Under the

169 The *Diamond* court did indicate that a Rule 10b-5 violation may have occurred but only because the defendants' conduct may have defrauded the *transacting shareholders*. *See* Diamond v. Oreamuno, 248 N.E. 2d 910 (N.Y. 1969).

170 *See* Painter et al., *supra* note 12, at 182.

proposed SEC theory, section 10(b) would prohibit tippees from trading on material, nonpublic information if they know or should know that the tip came directly or indirectly from a fiduciary of the shareholders.[171] The Court simply would have to decide whether the information is material and nonpublic.[172] The *Dirks* theory looks to whether tippers breach their fiduciary duties in tipping. Since there was no breach of fiduciary duty in *Carpenter*, the *Dirks* theory did not reach the tippees. Consequently, the Court had to find yet another means of reaching what looked like insider trading conduct.

Second and perhaps more importantly, *Carpenter* perpetuates judicial scrutiny of securities information transfers, thereby facilitating acceptance of the misappropriation theory. In *Carpenter*, the Court expanded the definition of "fraud" under the mail and wire fraud statutes to include misappropriation of information. The Court cited the *Restatement (Second) of Agency*,[173] yet left unclear why a violation of agency law also necessarily constituted fraud. Thus, *Carpenter* sets the stage for the adoption of misappropriation theory as the next logical step in the expansion of insider trading liability.

D. Circuits Divided on the Misappropriation Theory

Before *O'Hagan*, several circuits had already adopted the misappropriation theory into their insider trading law. The Second, Seventh, and Ninth Circuits endorsed the misappropriation theory, while the Fourth stood alone in opposition.[174] When *O'Hagan* came before the Eighth Circuit, it joined the Fourth in opposing the application of the misappropriation theory.[175] Although the Third Circuit may have adopted the misappropriation theory in dicta, it did not address the

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171 *See supra* Part II.B.1.

172 Although few would perceive the information as typical "inside information"—confidential corporate information—one still may characterize it as material and nonpublic. The information in *Carpenter* may be material because it consists of "influential recommendations by analysts." Dalley, *supra* note 12, at 1310. The information also may be nonpublic because it was leaked prior to publication. *See id.* Trading on this information is known as "scalping." *Id.*

173 *See Carpenter*, 484 U.S. at 28.

174 *See* United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995) ("We conclude that neither the language of section 10(b), Rule 10b-5, the Supreme Court authority interpreting these provisions, nor the purposes of these securities fraud prohibitions, will support convictions resting on the particular theory of misappropriation adopted by our sister circuits.").

175 *See* United States v. O'Hagan, 92 F.3d 612, 620 (8th Cir. 1996) ("We find the analysis from *Bryan* persuasive and have borrowed heavily from it in arriving at our conclusion. Therefore, we adopt that court's analysis in its entirety as our own."), *rev'd*, 521 U.S. 642 (1997).

theory by name.[176] This left the circuits divided three-to-two concerning the expansion of section 10(b) via the misappropriation theory.[177]

1. *The Second, Seventh, and Ninth Circuits*

In *United States v. Newman*,[178] the Second Circuit became the first to adopt the misappropriation theory. In *Newman*, the Second Circuit asserted that the misappropriator's breach of duty fulfilled the deception requirement of section 10(b).[179] It dismissed the issue of deception rather quickly, stating that

> [i]n other areas of the law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful. [It] would . . . be most ingenuous to believe that Congress intended to establish a less rigorous code of conduct under the Securities Acts.[180]

The *Newman* court also found that the misappropriator's conduct met the "in connection with" requirement because the purpose of the misappropriation was to use the information in securities trading.[181] While it refrained from doing so in *Newman*, the Second Circuit justified the application of the misappropriation theory in *United States v.*

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176 *See* Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985) ("An insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which he owes a duty of confidentiality.").

177 The circuits divided three-to-one on the validity of Rule 14e-3(a). The Second, Seventh, and Tenth Circuits included Rule 14e-3(a) in the evolution of insider trading. *See* SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995); SEC v. Peters, 978 F.2d 1162, 1165 (10th Cir. 1992); United States v. Chestman, 947 F.2d 551, 563 (2d Cir. 1991) (en banc). The Eighth Circuit, however, declined to recognize the validity of Rule 14e-3(a). *See* United States v. O'Hagan, 92 F.3d 612, 627 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

178 664 F.2d 12 (2d Cir. 1981).

179 *See id.* at 16.

180 *Id.* at 18 (citations omitted). A subsequent congressional report on insider trading quoted this statement of *Newman*. *See* H.R. REP. No. 98-355, at 5 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2278.

In *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), the Second Circuit also suggested that the principal suffers injury from the misappropriation. *See id.* at 202. A misappropriator jeopardizes the principal's "reputation as a safe repository for client secrets," thereby undermining its integrity. *Id.* The Second Circuit also quoted RESTATEMENT (SECOND) OF AGENCY § 395, stating that "an agent is subject to a duty to the principal not to use or to communicate information confidentially given to him by the principal or acquired by him during the course of or on account of his agency." *Id.* at n.4 (quoting RESTATEMENT (SECOND) OF AGENCY § 395 (1958) (misciting as § 359) (internal quotation marks omitted)).

181 *See Newman*, 664 F.2d at 18. In *Materia*, the Second Circuit presented a more resolute statement about the connection requirement: "The information [the misappropriator] stole has no value whatsoever except 'in connection with' his subsequent purchase of securities. The fraud perpetrated on his employer was part and parcel of a larger design, the sole purpose of which was to reap instant no-risk profits in the stock market." *Materia*, 745 F.2d at 203.

Materia[182] on the basis that this theory furthered the policy of the securities laws.[183] The *Materia* court stated, "We do not believe the drafters of the Securities Exchange Act of 1934—envisaging as they did an open and honest market—would have countenanced the activities engaged in by [the defendant]."[184]

In *SEC v. Clark*,[185] the Ninth Circuit became the next to approve of the misappropriation theory. In *Clark*, the court found that the misappropriation theory meets the section 10(b) "deception" and "in connection with" requirements, and that it effectuates the underlying policies.[186] First, the Ninth Circuit stated that the misappropriation theory reaches the *Carpenter* definition of fraud because it prohibits the use of confidential information in the breach of a fiduciary duty.[187] The court concluded that *Carpenter*'s analysis of the mail and wire fraud statutes applies to section 10(b) because the statutes contain similar language.[188] Second, the Ninth Circuit asserted that the misappropriator's conduct was "in connection with" trading, reasoning that his "sole purpose in obtaining the nonpublic information . . . was to make a fast buck by trading in . . . securities."[189] Third, the court indicated that legislative history and congressional action support the adoption of the misappropriation theory.[190] The Ninth Circuit pointed to general language in the legislative history prohibiting "manipulative or deceptive practices."[191] It also relied on reports accompanying the Insider Trading Sanctions Act of 1984 (ITSA)[192] and the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA)[193] in making its decision.[194] Neither of these statutes codifies the misappropriation theory; however, they do expand insider trading liability,[195] and their accompanying reports

182 745 F.2d 197, 203-04 (2d Cir. 1984).

183 *See id.*

184 *Id.*

185 915 F.2d 439 (9th Cir. 1990).

186 *See id.* at 449.

187 *See id.*

188 *See id.* at 448.

189 *Id.* at 449.

190 *See id.* at 450.

191 *Id.* (quoting S. REP. No. 73-792, at 18 (1934) (internal quotation marks omitted)).

192 Pub. L. No. 98-376, 98 Stat. 1264 (codified as amended in scattered sections of 15 U.S.C.).

193 Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

194 *See Clark*, 915 F.2d at 452.

195 Under ITSA, Congress codified section 20(d) of the Securities Exchange Act, 15 U.S.C. § 78t(d) (1994), prohibiting an individual from trading options on material, nonpublic information when trading on the underlying securities is illegal. *See id.*

Under ITSFEA, Congress enacted section 20A of the Securities Exchange Act, *id.* § 78t-I, providing civil remedies to victims of insider trading. Section 20A states in relevant part:

generally approve of a theory based on information misappropriation.[196]

In *SEC v. Cherif*,[197] the Seventh Circuit followed suit and adopted the misappropriation theory.[198] In *Cherif*, the Seventh Circuit likewise discussed whether the theory comports with the section 10(b) requirements and policy. The court suggested that the misappropriation theory fulfills the "deception" requirement because the theory reaches more than mere thievery.[199] A misappropriator betrays a trust: he uses information belonging to the principal, which the misappropriator gains only through a fiduciary relationship.[200] His actions are fraudulent "because they deprived some person of something of value by 'trick, deceit, chicane or overreaching.'"[201] The Seventh Cir-

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

Id. § 78t-1(a).

196 The report accompanying ITSA suggests that the antifraud provisions may prohibit the illegal use of information when one converts it for personal benefit in breach of a fiduciary duty:

> Since its creation, the [SEC] has appropriately used the antifraud provisions to remedy unlawful trading and tipping by persons in a variety of positions of trust and confidence who have illegally acquired or illegally used material non-public [sic] information.
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> . . . .
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> . . . For example, in certain widely-publicized instances, agents of tender offerors and persons contemplating a merger or acquisition have used for personal gain information entrusted to them solely for a business purpose. Such conversion for personal gain of information lawfully obtained abuses relationships of trust and confidence and is no less reprehensible than the outright theft of nonpublic information.

H.R. REP. No. 98-355, at 4-5 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277-78.

The report accompanying ITSFEA indicates that the misappropriation theory upholds the underlying policy of the Securities Exchange Act:

> [T]he codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory. The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful.

H.R. REP. No. 100-910, at 26-27 (1988) (citation omitted), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6063-64.

197 933 F.2d 403 (7th Cir. 1991) (en banc).

198 *See id.* at 410.

199 *See id.* at 412.

200 *See id.*

201 *Id.* (quoting McNally v. United States, 483 U.S. 350, 358 (1987)). The court also noted "[the] common sense notion of fraud" that underlies the misappropriation theory:

cuit did not substantively discuss the "in connection with" requirement, stating only that trading securities "in connection with" deception violates section 10(b).[202] As for the policy underlying section 10(b), the Seventh Circuit, like the Ninth Circuit, cited congressional reports suggesting general approval of the misappropriation theory.[203]

2. *The* Central Bank *Decision*

The Supreme Court's decision in *Central Bank v. First Interstate Bank*[204] represents a turning point for circuit court decisions regarding the misappropriation theory. In *Central Bank*, the Court held that one cannot maintain a private action for damages against a person who aided and abetted a section 10(b) and Rule 10b-5 violation.[205] In dicta, the Court stated that it would not expand the reading of section 10(b), suggesting that this interpretation would not sustain the broad misappropriation theory. The Court reaffirmed its narrow construction of *Chiarella*, asserting that section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[206] It also stated that a nondisclosure of material, nonpublic information violates section 10(b) only when there is "an independent duty of disclosure."[207] The Court further opined that "aiding and abetting a wrongdoer ought to be actionable in certain instances," but that the issue "is not whether imposing private civil liability on aiders and abettors is good policy but whether aiding and abetting is covered by the statute."[208] Thus, the Supreme Court indicated that it would not impose liability under the misappropriation theory if the theory is based on the underlying policy of the statute and not its language.

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

Id. at 410 (alteration in original) (quoting SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990) (internal quotation marks omitted)).

202 *Id.* ("We agree that buying or selling securities 'in connection with' fraud perpetrated on an employer to obtain material non-public information constitutes a violation of Rule 10b-5.").

203 *See id.* n.5.

204 511 U.S. 164 (1994).

205 *See id.* at 191.

206 *Id.* at 177.

207 *Id.* at 174. This assertion, however, slightly mischaracterizes the holding. In *Chiarella*, the Court held that mere possession of *material*, nonpublic information does not give rise to a duty to disclose. *See* Chiarella v. United States, 445 U.S. 222, 235 (1980). But it did not address whether this duty arises from possession of information *basic* to the transaction, and it did not explicitly reject the "basic facts" doctrine. *See infra* notes 316-18.

208 *Central Bank*, 511 U.S. at 177.

3. *The Fourth and Eighth Circuits*

In *United States v. Bryan*,[209] the Fourth Circuit rejected the misappropriation theory, determining that it does not fulfill the "deception" and "in connection with" requirements of section 10(b).[210] First, the Fourth Circuit invoked the Supreme Court's construction of section 10(b) in *Santa Fe Industries v. Green*,[211] contending that the fiduciary breach element of the misappropriation theory does not constitute deception under the Statute.[212] In *Santa Fe*, the Court stated that section 10(b) reaches acts specifically involving deceit but does not reach mere breach of fiduciary duty without deception.[213] Second, the Fourth Circuit argued that the breach is not "in connection with" the securities trading. According to the Fourth Circuit, the misappropriation theory "artificially divides into two discrete requirements—a fiduciary breach and a purchase or sale of securities—the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction."[214] When the Eighth Circuit encountered the misappropriation theory in *United States v. O'Hagan*,[215] it fully endorsed the ruling of the Fourth Circuit in *Bryan*.[216] Using the same reasoning, the Eighth Circuit held that section 10(b) cannot sustain the misappropriation theory.[217] It also held that Rule 14e-3(a) exceeds the SEC's rule-making authority because it dispenses with the breach-of-fiduciary-duty requirement.[218]

III
UNITED STATES V. O'HAGAN

A. Facts

Defendant James H. O'Hagan, a partner at the law firm of Dorsey & Whitney, received confidential information regarding a possible tender offer by the firm's client Grand Met for the target company Pillsbury Madison.[219] O'Hagan did no work for Grand Met,[220] but

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209 58 F.3d 933 (4th Cir. 1995).

210 *See id.* at 944.

211 430 U.S. 462 (1977).

212 *See Bryan*, 58 F.3d at 949.

213 *See Santa Fe*, 430 U.S. at 476.

214 *Bryan*, 58 F.3d at 950. The Fourth Circuit seemingly embraced the RESTATEMENT (SECOND) OF TORTS § 551(2)(a) perspective. *Cf. supra* note 175 and accompanying text.

215 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

216 *See supra* note 175.

217 *See O'Hagan*, 92 F.3d at 622.

218 *See id.* at 627.

219 *See* United States v. O'Hagan, 521 U.S. 642, 647-48 (1997).

220 *See id.* at 647.

received this information through the law firm.[221] He purchased Pillsbury securities prior to the tender offer and then sold the securities once Grand Met publicly announced its tender offer earning a profit of over $4.3 million on the transaction.[222]

O'Hagan was arrested and charged with fifty-seven counts of securities fraud under section 10(b) of the Securities Exchange Act and Rule 10b-5, fraudulent trading under section 14(e) of the Act and Rule 14e-3(a), federal mail and wire fraud, and money laundering.[223] In the district court, a jury convicted O'Hagan on all counts.[224] On appeal, the Eighth Circuit reversed all of O'Hagan's convictions.[225] The Government appealed,[226] and the Supreme Court granted certiorari.[227]

B. Recharacterization of the Misappropriation Theory

In light of *Central Bank*, *Bryan*, and its own defeat in the Eighth Circuit, the Government confronted two main hurdles in arguing for the adoption of the misappropriation theory: it had to establish that the theory meets both the "deception" requirement and the "in connection with" requirement of section 10(b).[228] Consequently, in its briefs and in oral argument, the Government carefully recharacterized the misappropriation theory to fulfill these requirements.[229]

The Government advocated an expanded construction of section 10(b)'s "deception" requirement. Under the Court's interpretation in *Chiarella*, section 10(b) reaches common law fraud under the *Restatement (Second) of Torts* § 551(2)(a) doctrine—nondisclosure in a transaction between fiduciaries.[230] The Government argued that "the securities laws are not framed to pick up only those violations that are covered by common law fraud," but a range of "deceptive devices."[231]

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221 *See id.* at 648 & n.1.

222 *See id.* at 647-48.

223 *See id.* at 648-49.

224 *See id.* at 649.

225 *See* United States v. O'Hagan, 92 F.3d 612, 614 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

226 The Government allowed the Eighth Circuit's reversal of O'Hagan's money laundering convictions to stand. *See O'Hagan*, 521 U.S. at 678 n.24.

227 *See* United States v. O'Hagan, 519 U.S. 1087 (1997).

228 *See* Pritchard, *supra* note 12, at 37. The Government also had to defend the misappropriation theory against the defendant's arguments on these issues. *See* Brief for Respondent at 12-33, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842).

229 The Court's opinion in *O'Hagan* frequently cites the Government's brief, and at least one commentator believes that the oral argument may have decided the case for the Government. *See, e.g.*, Pritchard, *supra* note 12, at 41.

230 *See supra* Part II.A.1.

231 Transcript of Oral Argument at *7, *O'Hagan* (No. 96-842), *available in* 1997 WL 182584.

This reading of section 10(b), argued the Government, allows for the adoption of the misappropriation theory.[232] The theory does not reach common law fraud, but it does prohibit the *Carpenter* species of fraud. According to the Government, a violation of section 10(b) occurs when "a trusted agent defrauds the legitimate owner of the right of exclusive use of its information and reaps illicit profits by employing the information in securities trading."[233] Citing *Carpenter*, the Government noted that when "an unfaithful agent maintains a pretense of loyalty to the principal while secretly converting the principal's information for personal gain," this conversion is a "species of fraud" and meets the section 10(b) "deception" requirement.[234]

The Government also suggested that the section 10(b) "in connection with" requirement does not necessarily mean that the deception must occur between parties to the transaction, as *Bryan* asserts and as *Chiarella* and *Dirks* imply:

> Congress did not pass a law even that said that it is unlawful to commit fraud in a securities transaction. It passed a law with a broader phrase, in connection with a securities transaction, because the very aim of this section was to pick up unforeseen, cunning, deceptive devices that people might cleverly use in the securities markets[.][235]

The Government argued that the misappropriation theory meets the "in connection with" requirement of section 10(b) because the misappropriator only can realize the value of inside information in the securities market.[236] Thus, a misappropriator's deceptive breach and his trading are connected—the trade consummates the breach.[237]

The Government further expressed valid policy reasons for adopting the misappropriation theory. It argued that "investors do

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232 *See id.* at *6-8

233 Brief for the United States at 15, *O'Hagan* (No. 96-842). In its Reply Brief, the government elaborated on how the misappropriation theory fulfills the "deception" requirement:

> [L]iability under the misappropriation theory is premised on the fact that the particular breach of duty involved in the conversion of confidential information that has been entrusted to one for a limited purpose inherently involves deception. Thus, under well settled principles, before an agent may use his principal's confidential business information for his personal benefit, he must make disclosure to the principal and obtain the principal's consent; the breach of that duty thus inherently involves deceptive nondisclosure.

Reply Brief for the United States at 6, *O'Hagan* (No. 96-842).

234 Brief for the United States at 17.

235 Transcript of Oral Argument at *7.

236 *See* Reply Brief for the United States at 11 (arguing that nonpublic information has "no value" to the misappropriator "except as it might enable him to reap windfall profits in the securities market (or enable someone else to reap such profits, through illegal tipping)").

237 *See id.*

assume that they are not trading with someone who acquired the informational advantage simply by fraud, simply by stealing information in breach of a fiduciary duty and using it for trading."[238] Thus, by advocating a broader definition of deception, by asserting that information misappropriation constitutes a species of fraud, by demonstrating the connection between the deception and the securities trading, and by showing how the theory comports with the underlying policy, the Government bolstered its argument for the adoption of the misappropriation theory.

C. The Decision

The Supreme Court reversed the Eighth Circuit and remanded for further proceedings.[239] A six-to-three majority held that section 10(b) and Rule 10b-5 liability may be predicated on the misappropriation theory.[240] Under the misappropriation theory, an individual violates the statute when he trades securities on the entrusted information of his fiduciary while feigning loyalty to the fiduciary.[241] The majority stated that this theory complies with the statutory language and purpose of section 10(b) and that the theory is consistent with established section 10(b) jurisprudence.[242]

Dissenting from this part of the opinion, Justice Scalia asserted that the Court should have invoked the principle of lenity.[243] This principle compels a court to interpret ambiguity in a criminal statute in the light most favorable to the defendant.[244] Justice Scalia argned that the reading most favorable to the defendant suggests that a section 10(b) violation occurs only when the trader deceives his transacting counterpart, not a third party.[245]

Justice Thomas, along with Chief Justice Rehnquist, also dissented from the Court's ruling on the misappropriation theory.[246]

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238 Transcript of Oral Argument at *26.

239 *See* United States v. O'Hagan, 521 U.S. 642, 678 (1997); *see also* United States v. O'Hagan, 139 F.3d 641, 645 (8th Cir. 1998) (affirming O'Hagan's securities fraud and mail fraud convictions and remanding to the district court for resentencing).

240 *See O'Hagan*, 521 U.S. at 650.

241 *See id.* at 653-54.

242 *See id.* at 649-66. The Court declined to address whether Chief Justice Burger's theory of misappropriation in *Chiarella* similarly complied with section 10(b). The Court indicated that the Government did not propose the former Chief Justice's theory. *See id.* at 655 n.6. However, the North American Securities Administrators Association, Inc. (NASAA) Brief indicated that Chief Justice Burger's theory was the sounder theory and suggested that the Court adopt it. *See infra* note 282.

243 *See O'Hagan*, 521 U.S. at 679 (Scalia, J., concurring in part and dissenting in part).

244 *See* United States v. Bass, 404 U.S. 336, 348 (1971) ("[W]here there is ambiguity in a criminal statute, doubts are resolved in favor of the defendant.").

245 *See O'Hagan*, 521 U.S. at 679 (Scalia, J., concurring in part and dissenting in part).

246 *See id.* at 680 (Thomas, J., concurring in the judguent in part and dissenting in part).

Thomas argued that the adopted version of the theory "fails to provide a coherent and consistent interpretation" of section 10(b) and Rule 10b-5.[247] He asserted that the misappropriation theory does not meet the "in connection with" requirement, nor does it comport with the underlying policy of the securities laws.[248]

The Court also reversed the Eighth Circuit with respect to the section 14(e) and Rule 14e-3(a) convictions and the mail and wire fraud convictions. A seven-to-two majority held that Rule 14e-3(a) is a valid exercise of the SEC's authority against O'Hagan.[249] Justice Thomas and Chief Justice Rehnquist dissented, asserting that the SEC had exceeded its rule-making authority under section 10(b) when it promulgated 14e-3(a).[250] The Court unanimously upheld O'Hagan's mail and wire fraud convictions.[251]

IV
ANALYSIS OF THE MISAPPROPRIATION THEORY

This Part discusses the merits of the misappropriation theory of *O'Hagan* in light of the Court's majority and minority opinions. Although the majority asserted that the misappropriation theory meets section 10(b)'s "deception" and "in connection with" requirements, that it comports with the Act's market integrity policy, and that it is consistent with prior case law, this Part argues that the misappropriation theory not only fails in each instance, but also is cumbersome to apply.

A. The Statutory Requirements and the Misappropriation Theory

Analysis of the misappropriation theory must begin with the language of section 10(b).[252] According to the language of the statute, a violation of section 10(b) occurs when an individual uses a "deceptive device" "in connection with" securities trading.[253] In *O'Hagan*, the "deception" and "in connection with" requirements are major points

247 *Id.* (Thomas, J., concurring in the judgment in part and dissenting in part).

248 *See id.* at 680-92 (Thomas, J., concurring in the judgment in part and dissenting in part).

249 *See id.* at 666-67.

250 *See id.* at 694-95 (Thomas, J., concurring in the judgment in part and dissenting in part).

251 *See id.* at 678.

252 "The starting point in every case involving construction of a statute is the language itself." Blue Chip Stamps v. Manor Drug Stores 421 U.S. 723, 756 (1975) (Powell, J., concurring).

253 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1994).

of contention in reconciling the misappropriation theory with judicial interpretation of section 10(b).[254]

1. *The Deception Requirement*

The majority asserted that the misappropriation theory fulfills section 10(b)'s "deception" requirement.[255] According to the majority, "A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain,' . . . defrauds the principal."[256] Justice Thomas, who ultimately dissented from the adoption of the misappropriation theory, also agreed with the majority's ruling that a fiduciary's misappropriation of confidential information constitutes a "deceptive device" under section 10(b).[257] The resolution of this issue, however, is not so clear.

The majority's reading of the statutory language in *O'Hagan* constitutes a significant departure from the Court's prior construction of section 10(b). In *Chiarella*, the Court interpreted the deception element of section 10(b) to reach only fraud.[258] Such a narrow construction cannot sustain the misappropriation theory, however, because an undisclosed breach of a duty of loyalty does not fit under the *Restatement (Second) of Torts* § 551(2) definition of fraud.[259] Section 551(2) recognizes fraudulent disclosure between *transacting* fiduciaries.[260] In the misappropriation context, the fiduciary relationship exists outside the transaction. Thus, to apply the misappropriation theory in *O'Hagan* the majority had to expand the definition of deception under section 10(b) to reach the species of fraud in *Carpenter*—the misappropriation of entrusted information, a breach of a duty of loyalty.[261] As noted above, however, *Carpenter*'s application of mail and wire fraud to the securities laws is suspect because it is not clear that

254 *See* Brief for Respondent, *O'Hagan* (No. 96-842).

255 *See O'Hagan*, 521 U.S. at 653.

256 *Id.* at 653-54 (first alteration in original) (citation omitted) (quoting Brief for the United States at 17).

257 *See id.* at 680 (Thomas, J., concurring in the judgment in part and dissenting in part).

258 *See supra* note 71 and accompanying text.

259 Section 551 is the relevant fraud doctrine because *Chiarella* interprets insider trading as an act of fraudulent nondisclosure in a transaction. *See supra* notes 67, 72 and accompanying text.

One commentator suggests, however, that deception under section 551(2)(a) and deception under the misappropriation theory are not all that different: "In reality, corporate shareholders are no more deceived by an insider, temporary insider, or tippee's trades, at least when they occur on a stock exchange or other impersonal market, than are the persons from whom material, nonpublic information has been misappropriated." Weiss, *supra* note 12, at 421.

260 For further discussion of nondisclosure liability under section 551(2), see *infra* Part V.

261 *See O'Hagan*, 521 U.S. at 653-54.

mere fiduciary breach constitutes fraud in light of *Santa Fe*[262] or that misappropriating information constitutes embezzlement—a species of fraud.[263]

The deception that the majority found in *O'Hagan* was that the misappropriator failed to disclose to the principal his intent to use confidential information in trading. The argument that this nondisclosure constitutes "deception" under section 10(b) fails for two reasons. First, the disclosure of the agent's intent to misappropriate does not necessarily prevent or cure the insider trading conduct (as it does under the other theories). Notifying the source of the information does not prevent the trade, does not alert the transacting counterparties, and thus, does not protect innocent investors.[264] Consequently, nondisclosure under the misappropriation theory does not constitute "a material misrepresentation or material failure to disclose" that the Court required in *Santa Fe*.[265] Second, if the agent ever deceives the principal as to his loyalty, it is when the principal unwittingly discloses the information to a disloyal or potentially disloyal agent, not when the agent manifests his disloyalty by trading.[266] A principal probably discloses confidential information to the agent on the belief that the agent is and will remain loyal. A principal cannot later deprive the agent of the information if the agent disavows his loyalty.[267] If deception occurs prior to trading, then under the majority's interpretation of the section 10(b), the misappropriator's conduct does not meet the "in connection with" requirement.

Even if the Supreme Court's more expansive reading of section 10(b) had required merely a deceptive breach, and if a duty of loyalty breach had constituted a statutory violation, the Court could have reconsidered the pre-*Chiarella* fairness approach before adopting the misappropriation theory. Surely a breach of a contractual duty of good-faith dealing under the fraudulent misrepresentation doctrine is at least as deceptive as a breach of a duty of loyalty.[268] The notion of contractual misrepresentation also better addresses the policy underlying the Securities Exchange Act—the protection of uninformed transacting parties. By focusing on a breach of a duty of loyalty, the *O'Hagan* Court may have decided that it was easier to retract its statu-

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262 *See supra* note 213 and accompanying text.

263 *See supra* Part II.C.3.

264 *See infra* notes 288-91 and accompanying text.

265 Santa Fe Indus. v. Green, 430 U.S. 462, 474 (1977).

266 *Cf. O'Hagan*, 521 U.S. 642 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.").

267 *Cf.* Painter et al., *supra* note 12, at 182, 184 (arguing that because information is both a public good and intangible, it is impossible to deprive one of information that one has already acquired).

268 For a discussion of contractual fraudulent misrepresentation, see *supra* Part I.B.

tory interpretation (that section 10(b) catches only fraud), which formed the basis of its holding in *Chiarella*, rather than the holding itself (that there is no duty of good-faith dealing between individuals trading on a securities exchange).

2. *The "In Connection With" Requirement*

The majority's argument that the misappropriation theory fulfills section 10(b)'s requirement of deception "in connection with" trading[269] also is unconvincing. The majority noted that the language of section 10(b) "does not confine its coverage to deception of a purchaser or seller of securities; rather, the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'"[270] According to the majority, the required "connection" between deception and trading exists under the misappropriation theory when the two events coincide: "[T]he [misappropriator]'s fraud is consummated . . . when . . . he uses the [confidential] information to purchase or sell securities."[271] The majority contrasted insider trading with embezzlement, stating that embezzling money to fund trading does not fulfill the "in connection with" requirement because an individual completes the embezzlement prior to trading and can use the money for other ends.[272]

Justice Thomas, however, asserted that the misappropriation theory does not fulfill the "in connection with" requirement of section 10(b), suggesting that the majority's interpretation of the requirement is inconsistent.[273] First, he attacked the majority's assertion that fraud is "in connection with" trading because trading consummates the breach of duty.[274] In response to the majority's embezzlement hypothetical, Justice Thomas offered his own hypothetical to demonstrate how embezzlement may meet the majority's "in connection with" requirement: "[In] an embezzlement . . . via the mechanism of a securities transaction . . . where a broker is directed to purchase stock for a client and instead purchases such stock—using client funds—for his own account[,] . . . the 'securities transaction and the breach of duty thus coincide.'"[275]

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269 *See O'Hagan*, 521 U.S. at 655-56.

270 *Id.* at 651 (citation omitted).

271 *Id.* at 656.

272 *See id.* at 656-57.

273 *See id.* at 680-92 (Thomas, J., concurring in the judgment in part and dissenting in part).

274 *See id.* at 680-85 (Thomas, J., concurring in the judgment in part and dissenting in part).

275 *Id.* at 685 (Thomas, J., concurring in the judgment in part and dissenting in part) (citations omitted). Thomas offered another hypothetical to demonstrate how tipping consummates the fraud prior to trading. *See id.* at 686 n.2 (Thomas, J., concurring in the judgment in part and dissenting in part). Thomas further pointed out that the statute

In response to Justice Thomas, the majority argued that misappropriated information is connected more intimately to securities trading than embezzled money because this information *ordinarily* guides trading that seeks to capitalize on no-risk profits.[276] Justice Thomas in turn pointed out that the Government's proposed misappropriation theory claimed that the information assists *only* in securities trading.[277] He argued that the Court lacked the authority to modify this theory,[278] and he then indicated other uses of misappropriated information.[279]

This exchange suggests that the majority analogized misappropriation and embezzlement selectively. The majority implied that misappropriation is like the embezzlement of information, and because embezzlement is fraud, misappropriation is fraud.[280] After arguing that the similarities prove that the misappropriation theory fulfills the deception requirement, however, the Court distinguished misappropriation and embezzlement to qualify the "in connection with" requirement.

In one sense the Court's intuition is correct: many regard insider trading as trading on inside information, not as embezzlement-funded trading.[281] After all, embezzling does not affect the securities market. But because the misappropriation theory can reach either conduct, perhaps the Court should have realized the improper focus of the theory. Insider trading theory, then, should target deceptive uses of inside information in connection with trading. This information is important not because it is *ordinarily* used in evaluating which securities to trade, but because it is *nonpublic.* The "inside-ness" of the information is what makes the information notable.[282]

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does not prohibit only the misappropriation of information; thus, there is no reason why, under the accepted theory, section 10(b) would not prohibit the type of embezzlement in Thomas's hypothetical. *See id.* at 688 n.4 (Thomas, J., concurring in the judgment in part and dissenting in part).

276 *See id.* at 657-58.

277 *See id.* at 684 (Thomas, J., concurring in the judgment in part and dissenting in part).

278 *See id.* at 687 (Thomas, J., concurring in the judgment in part and dissenting in part) ("It is a fundamental proposition of law that this Court may not supply a reasoned basis for the agency's action that the agency itself has not given." (internal quotation marks omitted) (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983))).

279 *See id.* at 686 (Thomas, J., concurring in the judgment in part and dissenting in part); *see also id.* at 657 n.8 (indicating other uses of misappropriated information).

280 *See id.* at 654.

281 *See supra* note 30.

282 *See infra* note 288 and accompanying text.

The amici brief of NASAA for the Petitioner endorsed Chief Justice Burger's theory. *See* Brief of *Amici Curiae* North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner at 12, *O'Hagan* (No. 96-842).

B. Section 10(b) Policy and the Misappropriation Theory

At first blush, the misappropriation theory is appealing from a policy standpoint because of its dual function: it prevents an individual from exploiting a fiduciary relationship by trading on confidential information, and as a result, it indirectly protects the integrity of the securities markets from fraudulent practices.[283] The theory shifts the focus, however, of insider trading prohibition from tainted securities transactions to tainted fiduciary relationships. Yet Congress enacted the Securities Exchange Act to address the former and not the latter.[284] A closer examination reveals that the misappropriation theory

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In support of his theory in *Chiarella*, the Chief Justice cited Professor Keeton's proposal:

> [T]he way in which the buyer acquires the information which he conceals from the vendor should be a material circumstance. The information might have been acquired as the result of his bringing to bear a superior knowledge, intelligence, skill or technical judgment; it might have been acquired by mere chance; or it might have been acquired by means of some tortious action on his part. . . . *Any time information is acquired by an illegal act it would seem that there should be a duty to disclose that information.*

Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) (alterations in original) (quoting Keeton, *supra* note 82, at 25-26 (internal quotation marks omitted)). Even if Chief Justice Burger's theory meets the "deception" and "in connection with" requirements, however, it is not clear that a misappropriator inherits an obligation to the shareholders. As one commentator stated:

> There is virtually no authority for the view that a defendant who has unlawfully obtained information, or improperly converted information to his own use, is subject to an absolute duty to disclose it to those with whom he transacts business. The only authority that the Chief Justice cited in support of his theory argued that "there *should* be a duty," not that there *is* a duty, to disclose information that was acquired illegally.

Aldave, *supra* note 106, at 106.

283 As one amici brief stated:

> When [a misappropriator] use[s] material nonpublic information obtained in the course of a special relationship of trust and confidence to trade securities for his personal benefit in breach of his fiduciary duties, he injure[s] both the corporation whose secrets and plans had heen entrusted to him and his law firm, whose confidence he betrayed, and he undermine[s] the efficiency and integrity of the securities markets.

Brief of *Amici Curiae* North American Securities Administrators Association, Inc., and Law Professors in Support of Petititoner at 4-5, *O'Hagan* (No. 96-842).

If the market integrity purpose of the Act alone could support the misappropriation theory, it also could support the fairness approach that *Chiarella* rejected. *See* Seligman, *supra* note 12, at 18-19.

284 *See supra* note 27 and accompanying text. "Congress's purpose in enacting the statute . . . was to protect the integrity of securities markets, not to create a property right to information." Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 10, *O'Hagan* (No. 96-842). "Congress could *develop* a statutory definition of the proscribed conduct based on a theory of property rights in information. . . ." *Id.* at 28 (emphasis added). It seems improper, however, for the Court to construe a law which seeks to protect public securities markets to govern private fiduciary relationships. For one commentator's proposed property rights approach, see Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189 (1995).

not only fails to implement the purpose of the statute, but it also fails to protect the integrity of fiduciary relationships.

1. *Misappropriation Theory and Protection of Public Investors*

In *O'Hagan*, the Supreme Court determined that the misappropriation theory fulfills the purpose of the Act by preventing deception between fiduciaries in connection with trading.[285] The majority claimed that because the theory prohibits informational advantage through contrivance rather than skill or luck, it thereby insures honest securities markets.[286] Justice Thomas, however, after arguing that the misappropriation theory fails to meet section 10(b)'s requirements, stated that "it is not illegal to run afoul of the 'purpose' of a statute, only its letter."[287] Even if the misappropriation theory fulfills these requirements, Justice Thomas asserted, it fails to serve the underlying policy of section 10(b). He claimed that the majority's endorsement of the protection of fiduciary relationships that are external to the trading "glosses over the fact that the supposed threat to fair and honest markets, investor confidence, and market integrity comes not from the supposed fraud [or information misappropriation,] . . . but from the mere fact that the information used by [the defendant in trading] was nonpublic."[288] He noted that if a source of information were to grant authority to trade on confidential information, then under the misappropriation theory an "outsider" legally could exploit his informational advantage over the unwary investor who "has no hope of obtaining [nonpublic information] through his own diligence."[289] Justice Thomas further stated, "As far as the market is concerned, a trade based on confidential information is no more 'honest' because some third party may know of it so long as those on the other side of the trade remain in the dark."[290] Thus, a

285 *See O'Hagan*, 521 U.S. at 658-59.

286 *See id.*

287 *Id.* at 689 (Thomas, J., concurring in the judgment in part and dissenting in part).

288 *Id.* (Thomas, J., concurring in the judgment in part and dissenting in part). Deception of the source may not have "anything to do with the confidence or integrity of the market." *Id.* at 691 (Thomas, J., concurring in the judgment in part and dissenting in part); *see also* Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 21, *O'Hagan* (No. 96-842) ("[I]nsider trading liability 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 or even a market participant at all.").

289 *O'Hagan*, 521 U.S. at 689-90 (Thomas, J., concurring in the judgment in part and dissenting in part).

290 *Id.* at 690 n.6 (Thomas, J., concurring in the judgment in part and dissenting in part); *see also* Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 30, *O'Hagan* (No. 96-842) ("An investor who has paid too much for stock or sold it for too little in a transaction with a person in possession of material nonpublic information suffers loss irrespective of whether the counterparty breached a fiduciary duty to a third party.").

trader gains his advantage through the use of nonpublic information, whether or not he deceives the source in acquiring it.[291]

If the policy underlying the statute is to protect the fiduciary relationship, then the law should protect the relationship for its own sake, not just as a means to protect the securities markets. If the underlying policy is to protect the integrity of the securities markets, then the law explicitly should do so.[292]

2. *Protection of Fiduciaries*

The misappropriation theory not only fails to promote market integrity by protecting fiduciary relationships, but in some cases it also fails to protect the relationships themselves.[293] This failure is especially apparent with respect to the misappropriation theory's disclosure rule.

In the classical context, in which the insider possesses nonpublic information about his company's securities, the duty to disclose seems appropriate. Disclosure prevents the insider from exploiting his uninformed fiduciary shareholders, and under corporate law, it prevents an officer from using corporate information personally to benefit at the expense of these shareholders.[294] In the misappropriation context, however, the trader has no fiduciary relationship with these shareholders and thus has no duty to disclose. To require the trader

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Professor Coffee has asserted, however, that selective disclosure or permissive use of inside information, though detrimental to the market, differs from insider trading:

> [E]ven if selective disclosure impairs market efficiency and injures investors, there is a strong case for defining it to be a separate offense from insider trading. Insider trading is, after all, criminally punishable by sentences of up to 10 years, and there seems little reason to constantly expose pension and mutual fund managers to this threat on a virtually daily basis because they might hear too much in an analyst conference call.

Coffee, *supra* note 11, at 5 (footnote omitted).

291 *See O'Hagan*, 521 U.S. at 690 n.7 (Thomas, J., concurring in the judgment in part and dissenting in part).

The misappropriation theory's protection of fiduciary relationships derives from agency law. *See id.* at 654-55 (citing RESTATEMENT (SECOND) OF AGENCY §§ 390, 395 (1958)). The problem is that insider trading probably does little, if any, harm to the source. *See* Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. CORP. L. I, 10-11 (1993) (indicating that insider trading has a minimal effect on the share price). There is, moreover, some suggestion that it may even benefit the source. *See* Painter, *supra* note 12, at 192 (indicating that insider trading would help the bidder put target shares in friendly hands). Thus, it is unclear how the misappropriator *defrauds* the source through trading.

292 If the purpose of the misappropriation theory is to protect the integrity of the market, "why should it matter whether the source of misappropriated information has been deceived?" Weiss, *supra* note 12, at 433.

293 "There are forms of improper conduct that section 10(b) does not reach, and the reason why section 10(b) does not reach them is it is a statute that is framed to reach fraudulent deceptive activity in connection with securities trading." Transcript of Oral Argument at *6, *O'Hagan* (No. 96-842).

294 *See supra* note 74 and accompanying text.

to disclose nonpublic information to the source (with whom he does have a fiduciary relationship) seems nonsensical.[295] The misappropriation theory, then, requires that the trader disclose his *intent* to trade securities on the entrusted information to the source:

> Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.[296]

Disclosure allows the trader to skirt federal sanctions under the misappropriation theory, but it does not protect the fiduciary relationship.[297] In other words, disclosure does not cure a breach of the fiduciary duty of loyalty; it merely informs the principal of the misappropriator's *dis*loyalty. Because the misappropriation theory is based on agency law,[298] a duty to obtain consent more easily reconciles with the misappropriation theory.[299] As Justice Thomas pointed out, however, trading with the principal's consent does not protect the public investor from an information disadvantage that he cannot possibly overcome.[300]

Implicit in the protection of the fiduciary relationship is the prevention of the illegitimate acquisition or use of inside information. Based on the Court's analysis, the misappropriation theory fails to reach trading on stolen inside information and trading on a misappropriator's tip. For example, if a nonfiduciary of O'Hagan had stolen his briefcase containing nonpublic information and then traded on that information, the thief's conduct may not fall under the scope of the misappropriation theory because there was no deceptive breach

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295 *See* Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 6 n.5, *O'Hagan* (No. 96-842) ("This duty of 'disclosure' is one that logically can only be owed to investors in the market, not to the source of nonpublic information (who presumably already knows the information and would want to keep it confidential).").

296 *O'Hagan*, 521 U.S. at 655.

297 The Court noted that even if a trader receives consent, he may still be liable under Rule 14e-3(a) if he trades in a tender offer context. *See id.* at 659 n.9.

298 *See supra* note 289.

299 Even if disclosure protects the source of information, there remains the following question: to which source does the trader owe the duty to disclose? In other words, if there is a long chain of communication (from an "outside" entity) before the actual trading occurs, does the trader have a duty to disclose his intent to trade to the person from whom he received the information, to the ultimate source of information to whom he may have no relation, or to everyone in the chain? *See* Coffee, *supra* note 11. One may question whether the trader must make a disclosure *at all* if he owes no duty of loyalty or confidentiality to anyone in the tipping chain. *See id.*

300 Although this arrangement prevents the trader from defrauding his source, the permissive use of confidential business information puts the uninformed public investor on inferior footing. *See supra* Part IV.B.1.

of fiduciary duty.[301] In addition, if O'Hagan had conveyed inside information to a nonfiduciary tippee and the tippee trades on that information, neither O'Hagan—the misappropriating tipper—nor the trading tippee is liable under the misappropriation theory.[302] This breach of fiduciary duty—the tipping—does not coincide with securities trading, and consequently, does not meet the "in connection with" requirement.[303] Thus, it should not be surprising that the misappropriation theory, which allows fiduciaries to trade on illegitimately acquired inside information, also allows non-fiduciaries to trade on illegitimately acquired inside information.

C. Consistency with Prior Case Law

The Court characterized the misappropriation theory as "complementary" to the classical theory,[304] reasoning that "it makes scant sense to hold . . . O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder."[305] The complementarity ends here, however. A comparison of existing insider trading theories—as Table 5 displays—demonstrates that the misappropriation theory is consistent with preexisting law only in the sense that it contains a hodgepodge of elements from prior insider trading theory. Although the misappropriation theory in *O'Hagan* incorporates elements of the fairness approach, *Chiarella*'s classical theory, *Dirks*'s tippee theory, and *Carpenter*'s species of fraud, it fails to fuse these elements into a liability theory that is consistent with any prior formulation.

The misappropriation theory's incongruity with the duty to disclose appears most clearly in a takeover context. If the trader works for the target (or he receives a top from a target insider), he has a

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301 *See* Transcript of Oral Argument at *5, *O'Hagan* (No. 96-842). *See also* Seligman, *supra* note 12, at 22. ("*O'Hagan*, by emphasizing fiduciary duties, seems just as clearly to preclude holding inadvertent or accidental recipients of material nonpublic information liable. . . . Similarly, an old fashioned burglar apparently need not fear Rule 10b-5. He violates the criminal law, but not a fiduciary or similar duty.").

If the misappropriation theory governs the illegitimate acquisition of trading information, it would intuitively prohibit both deceptive misappropriation and theft of information. *See* H.R. REP. No. 98-355, at 4-5 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2277-78 ("Such conversion for personal gain of information lawfully obtained abuses relationships of trust and confidence and is no less reprehensible than the outright theft of nonpublic information.").

302 The *Dirks* tippee liability theory fails to reach this conduct as well because the *Dirks* theory only reaches a trading tippee whose tipper breached a fiduciary duty to the transacting shareholders. *See supra* Part II.B. In the misappropriation-tippee context, the misappropriator-tipper does not owe a fiduciary duty to the transacting shareholders.

303 Generally, trading would occur some time after the tip if it in fact occurs at all. *See supra* note 145.

304 *O'Hagan*, 521 U.S. at 652. The Court also characterized the adoption of the misappropriation theory as consistent with *Chiarella* and *Dirks*. *See id.* at 660-63.

305 *Id.* at 659.

TABLE 5
THE EVOLUTION OF INSIDER TRADING JURISPRUDENCE

Theory	Deception	Trader's duty	Duty owed to whom?	Reason for duty
Chiarella classical theory (1980)	Nondisclosure under *Restatement of Torts* § 551(2)(a)	Disclose material, nonpublic information	Market	Fiduciary relationship
Rule 14e-3(a) promulgated by SEC (1980) and accepted in *O'Hagan* (1997)	Nondisclosure (in tender offer context) under *Restatement of Contracts* § 161(b)	Disclose material, nonpublic information	Market	Possession of material, nonpublic information
Dirks tippee theory (1983)	Nondisclosure	Disclose material, nonpublic information	Market	Tipper's breach of fiduciary duty in disclosing information to tippee
Carpenter "Species of Fraud" under the mail and wire fraud statutes (1987)	Deprivation of exclusive use of information	Obtain consent [No disclosure duty]	Principal(s) [No disclosure duty]	Misappropriation of information is like embezzlement and constitutes fraud
O'Hagan misappropriation theory (1997)	Nondisclosure of deprivation of right to exclusive use of information constituting fiduciary breach under *Restatement of Agency* § 395	Disclose intent to trade on fiduciary's confidential information	Source(s)	Unannounced misappropriation of information is a deceptive breach of fiduciary duty

duty to disclose the *information* to the *shareholders* under the classical theory, Rule 14e-3(a), and the tippee theory. If the trader works for the bidder, however, he has a duty to disclose his *trading intent* to the *sources* under the misappropriation theory. Ironically, the reason for adopting the misappropriation theory was to prevent just this sort of incongruity.

Admittedly, the misappropriation theory in *O'Hagan* resembles the rule that *Carpenter* articulates. The Court, however, mistakenly incorporated the *Carpenter* reasoning with regard to mail and wire fraud statutes in its interpretation of the securities laws, even though the relevant statutes contain similar language. The purposes of the statutes are different. The mail and wire fraud statutes seek to prevent a

perpetrator from using the services to commit or further fraud.[306] The securities laws, on the other hand, intend to protect public investors, not to guard corporate principals from disloyal agents.

D. The Problem of Application

Apart from its inconsistency with statutory requirements, policy, and prior case law, the misappropriation theory also presents practical problems of application. The misappropriation theory strives to protect the fiduciary relationship. Although the law certainly aims to protect corporate confidence, the federal securities law is not the proper means of achieving this goal.[307] State corporate law already governs internal corporate affairs, and thus, each state may define fiduciary relationships differently.

When the misappropriation theory premises criminal conduct on the existence of a fiduciary relationship, it creates "troubling consequences" because state laws contain different definitions of fiduciary relationships and duties.[308] To achieve uniform results across state lines absent congressional action, the courts would have to develop a federal common law of fiduciary relationships.[309] The Court discouraged this practice in *Santa Fe*, however, noting that federal regulation of fiduciary duties through the securities laws "would overlap and quite possibly interfere with state corporate law."[310] Thus, the misappropriation theory presents the theoretical problem of indirect protection and the practical problem of difficult application.

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306 *See* Brief for the United States, at 45, *O'Hagan* (No. 96-842). According to *Carpenter*, another purpose is to protect newspapers from disloyal journalists. *See* Carpenter v. United States, 484 U.S. 19, 28 (1987) ("We have little trouble in holding that the conspiracy here to trade on the [*Journal*]'s confidential information is not outside the reach of the mail and wire fraud statutes. . . .").

307 The misappropriation theory came before the Court in *Chiarella*, but the Government had not argued for the protection of third parties before the jury. *See* Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent, at 6, *O'Hagan* (No. 96-842). For the securities laws to govern an outsider's fiduciary relationships would be illogical: "[W]hether or not the 1934 Act imposed a general duty on all persons to disclose material nonpublic information before trading, the statute was not designed to condition a duty to disclose on a corporate outsider's relationship either with his employer or derivatively with his employer's customers." *Id.*

308 John C. Coffee, Jr., *From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics*, 19 AM. CRIM. L. REV. 117, 150 (1981) ("[S]ignificant differences exist among state jurisdictions in terms of the duties that fiduciaries owe, thereby possibly creating significant disparities in the coverage of federal criminal law depending on the applicable state civil law.").

309 *See* Brief of *Amici Curiae* Law Professors and Counsel in Support of Respondent at 25, *O'Hagan* (No. 96-842).

310 Santa Fe Indus. v. Green, 430 U.S. 462, 479 (1977). The Court noted, "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.*

V
RETHINKING INSIDER TRADING THEORY

The Supreme Court's rejection of the fairness approach and endorsement of section 551(2)(a) as the foundation of insider trading liability represent a critical misstep in the development of insider trading jurisprudence. The subsequent development of the classical and tippee theories, the promulgation of Rule 14e-3(a), and the emergence of the mail and wire fraud statutes together constitute a twisted path culminating in the misappropriation theory—a theory that lacks the statutory requirements, fails to comport with section 10(b) policy, is inconsistent with prior case law, and is difficult to apply across jurisdictions. Unfortunately, the *O'Hagan* Court declined the opportunity to adopt the *Restatement (Second) of Torts* § 551(2)(e) doctrine and eschew the cumbersome hydra of fiduciary-oriented theories. This Part proposes a simpler, more straightforward approach to the insider trading problem based on section 551(2)(e).

A. *Restatement (Second) of Torts* § 551(2)(e)

Restatement (Second) of Torts § 551(2) contains two subsections that arguably reach insider trading as a fraudulent transaction. In *Chiarella*, the Supreme Court quoted section 551(2)(a) to support its classical theory—that a duty to disclose arises in a transaction between fiduciaries.[311] The Supreme Court, however, has not referred to the "basic facts" doctrine of section 551(2)(e) with respect to insider trading in *Chiarella* or any other insider trading decision.[312] In relevant part, section 551(2) states:

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311 *See supra* note 72 and accompanying text. *Chiarella* also cites a law review article that supports the section 551(2)(e) doctrine. *See* Chiarella v. United States, 445 U.S. 222, 228 n.9 (1980) (citing Fleming James, Jr. & Oscar S. Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 523-27 (1978)).

312 In his *Chiarella* dissent, Justice Blackmun cited section 551(2)(e) and comment l of the RESTATEMENT (SECOND) OF TORTS, but only in reference to the "special facts" doctrine of *Strong v. Repide*, 213 U.S. 419 (1909). *See Chiarella*, 445 U.S. at 247-48 (Blackmun, J., dissenting). Blackmun suggested that the "special facts" doctrine and the "basic facts" doctrine are identical. *See id.* In *Strong*, the Court held that a duty to disclose arises in the presence of "special facts"; nondisclosure would make the transaction fraudulent. 213 U.S. at 431-33. *Strong*, however, involves a private suit for rescission of a contract between a minority shareholder and a director of a privately held company in a face-to-face transaction under foreign law. *See id.* at 428-31. The Court did not premise its decision on the fiduciary relationship between the parties. *See id.* at 431. Thus, applying the "special facts" doctrine to insider trading—involving anonymous shareholders of publicly held corporations in an impersonal transaction under federal law—is questionable. Demonstrating nondisclosure liability in a rescission of contract case is considerably easier. As RESTATEMENT (SECOND) OF CONTRACTS § 161(b) states:

> A person's non-disclosure of a fact known to him is equivalent to an assertion that the fact does not exist in the following cases only:
>
> . . . .

> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,
>
> (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and
>
> . . .
>
> (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.[313]

Thus, subsection (e) illustrates an additional way (aside from a fiduciary relationship) in which the duty to disclose arises. If *A* knows that *B* is mistaken as to the basic facts of the transaction—those facts that go to the essence of the transaction[314]—and that *B* reasonably would expect to be informed of these facts, then *A* has a duty to disclose.[315]

B. The Court's Silence on Section 551(2)(e)

The Supreme Court has been silent on the applicability of *Restatement (Second) of Torts* § 551(2)(e) to section 10(b) analysis and insider trading. In *Chiarella*, the Court seemed to reject the section 551(2)(e) doctrine when it rejected the fairness approach of *Cady, Roberts* and *Texas Gulf Sulphur*. A closer look reveals that this conclusion is not unassailable. In any case, what is clear is that the Court did not apply section 551(2)(e) to the insider trading problem and that it has yet to give the reasons behind this decision.

1. *Rejection of a Duty to Disclose Material Facts*

At first glance, the *Chiarella* Court appears to reject the "basic facts" doctrine outlined in section 551(2)(e) as a basis for nondisclosure liability: "Formulation of [a general duty between all participants in market transactions to forego actions based on material, nonpublic information] . . . departs radically from the established doctrine that duty arises from a specific relationship between two parties."[316] When

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> (b) where he knows that disclosure of the fact would correct a mistake of the other party as to a basic assumption on which that party is making the contract and if non-disclosure of the fact amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.

RESTATEMENT (SECOND) OF CONTRACTS § 161(b) (1981) (typeface altered).

313 RESTATEMENT (SECOND) OF TORTS § 551 (1977) (typeface altered).

314 For more discussion on what constitutes a "basic fact," see RESTATEMENT (SECOND) OF TORTS § 551 cmt. j (1977) (defining a basic fact as one "that is assumed by the parties as a basis for the transaction itself").

315 *See id.* § 551(2)(e).

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

the Court asserted that market traders have no duty to disclose "material" facts, however, it actually made no specific reference to section 551(2)(e) or to the "basic facts" doctrine.[317] The Court has defined an omitted fact as material "if there is a substantial likelihood that a reasonable shareholder would consider it important . . . [and] there [is] substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[318] A basic fact is a material fact that goes to the basis of the transaction. If *Chiarella* does reject the "basic facts" doctrine when it rejects the fairness approach, it offers no explanation why § 551(2)(a) represents the "established doctrine" of nondisclosure liability while § 551(2)(e) constitutes a "radical departure."

2. *A Newer Doctrine of Liability*

Whether or not the Supreme Court rejected section 551(2)(e) as part of nondisclosure liability, however, the Court certainly did not adopt it with respect to section 10(b) insider trading.[319] In *Chiarella*, the Court suggested that only the "established doctrine" of fraudulent nondisclosure articulated under section 551(2)(a) gives rise to section 10(b) liability.[320] Although section 551(2)(e) represents a newer doctrine of nondisclosure liability not widely recognized at the time the securities laws and regulations were drafted, the drafters probably intended the scope of the securities laws to conform to changing perceptions of fraud.

Under the traditional rule of nondisclosure, "[s]ilence does not constitute [actionable] concealment."[321] The law, however, has *never* applied this rule of nonliability to fiduciary relationships.[322] Because Congress drafted the Act in 1934 and the SEC drafted Rule 10b-5 in

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317 *See supra* note 71 and accompanying text.

318 TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976); *see also* Basic Inc. v. Levinson, 485 U.S. 224, 238-40 (1988) (adopting the *TSC* materiality test for Rule 10b-5).

319 *See supra* note 296 and accompanying text.

320 *Chiarella*, 445 U.S. at 233 ("[E]stablished doctrine [indicates] that duty arises from a specific relationship between two parties"). *See id.* at 230 ("[Nondisclosure] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."); *id.* at 232 ("No duty [to disclose] could arise . . . . He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence.").

321 James & Gray, *supra* note 311, at 523 (second alteration in original) (quoting Friedrich Kessler & Edith Fine, Culpa in Contrahendo, *Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401, 441 (1964) (internal quotation marks omitted)).

322 As McNulty and Hanson state:

> [T]he general rule of nonliability for silence never applied to fiduciaries. Under the common law of trusts, a fiduciary does not have the right to remain silent or inactive to the detriment of the beneficiary. Section 551 in effect lifts this preexisting rule from trust law and makes it a part of tort law.

1942, the Court may have believed that Congress and the SEC did not intend section 10(b) to prohibit acts within reach of today's broader nondisclosure liability doctrine. After all, the traditional doctrine only prohibited nondisclosure in a fiduciary relationship (section 551(2)(a)), and section 551(2)(e) did not appear in the *Restatement (Second) of Torts* until 1977. Thus, if the Court applied the modern trend of broader liability under section 551(2)(e), it could expand section 10(b) and Rule 10b-5 liability beyond what the drafters intended.

This argument for rejecting section 551(2)(e) is inaccurate at least in light of *O'Hagan*. The Supreme Court determined that section 10(b) reaches beyond the section 551(2)(a) definition of fraud.[323] Thus, if section 10(b) can extend to undisclosed duty of loyalty breaches under the misappropriation theory, as in *O'Hagan*, it also can reach a relatively new doctrine of fraud under section 551(2)(e). In fact, this broad reading of section 10(b) may even encompass the fraudulent misrepresentation of the fairness approach.

Moreover, the Supreme Court itself has recoguized that securities antifraud provisions should apply flexibly and encompass more than the technical meaning of fraud.[324] In *Ernst & Ernst v. Hochfelder*,[325] the Court asserted that Congress had intended securities legislation that it enacted for the purpose of avoiding frauds to "be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'"[326] Indeed, Congress and the SEC drafted section 10(b) and Rule 10b-5 in broad language, similar to constitutional provisions.[327] The unspecific language in turn has yielded "law [that] is surely as much judge made as is the classic common law."[328] Thus, the 1934 Congress and the 1942 SEC likely intended these antifraud provisions to evolve with and respond to changing circumstances.

If the definition of "fraud" can change and adhere to current legal and ethical attitudes,[329] then section 10(b) and Rule 10b-5 can

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Patrick J. McNulty & Daniel J. Hanson, *Liability for Aiding and Abetting by Silence or Inaction: An Unfounded Doctrine*, 29 TORT & INS. L.J. 14, 34 (1993).

323 *See supra* notes 264-68 and accompanying text.

324 *See* Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979); SEC v. Sloan, 436 U.S. 103, 116 (1978).

325 425 U.S. 185 (1976).

326 *Id.* at 200 (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (second internal quotation marks omitted))).

327 *See* LOSS & SELIGMAN, *supra* note 1, at 780 (suggesting that § 10(b) and Rule 10b-5 are "virtually as vague as the Due Process Clause").

328 *Id.* Insider trading "law is almost entirely the product of judicial and administrative construction." Langevoort, *supra* note 10, at 3.

329 Commentators have suggested:

> It is not the intent of this rule to provide a cause of action to every person who in retrospect feels he or she has made a bad deal. Rather, the rule's

reach conduct that the newer section 551(2)(e) proscribes. In other words, even if the "basic facts" doctrine "depart[ed] radically from the established doctrine"[330] when the Court decided *Chiarella*, the Court should have readdressed the issue seventeen years later in *O'Hagan*. Even in 1976, the "basic facts" doctrine represented a trend toward broader liability;[331] by 1997, even more case law must have emerged in support of section 551(2)(e).[332] Yet the *O'Hagan* Court unhesitatingly, or perhaps blindly, followed precedent without addressing the developing nondisclosure liability jurisprudence. If the Court wished to expand the construction of section 10(b), it should have included the doctrine of section 551(2)(e) rather than a theory predicated on an undisclosed fiduciary breach exterual to the transaction.

C. Application of *Restatement (Second) of Torts* § 551(2)(e)

Because the Supreme Court only affirmatively rejected a general duty to disclose "*material*, nonpublic information"[333] but did not address whether there was a duty to disclose facts *basic* to the transaction,[334] perhaps the Court was willing to recognize section 551(2)(e) as part of nondisclosure liability doctrine. It just may have felt that the "basic facts" doctrine does not apply to insider trading or section 10(b) liability under the presumption that inside information constitutes material facts but does not rise to the level of basic facts. Alternatively, the Court may have decided that inside information is basic to an insider trading transaction, but it concluded that insider trading fails to satisfy some other element of section 551(2)(e).

For section 551(2)(e) to apply, insider trading must meet three elements: (1) the undisclosed inside information goes to the essence of the transaction, (2) the trader knows his transacting counterparties

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> purpose is to deal with situations in which nondisclosure is abhorrent to society's sense of fairness. For example, failure to disclose in a house sale that the house is riddled with termites is so offensive that it is tantamount to swindling, and it is only in such circumstances that this rule finds its application.

McNulty & Hanson, *supra* note 322, at 36 (footnote omitted).

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

331 Recently, many exceptions have mitigated the harshness of the traditional rule, indicating a trend toward a broader rule of liability. *See* James & Gray, *supra* note 311, at 523-27. The basic facts doctrine did not exist in the original RESTATEMENT OF TORTS. The American Law Institute (ALI), however, proposed the current section 551(2)(e) in 1964 in response to nondisclosure cases that offended society's sense of equity. *See* RESTATEMENT (SECOND) OF TORTS § 551 (Tentative Draft No. 10, 1964). Nonetheless, it would be an exaggeration, if not disingenuous, to suggest that the basic facts doctrine "departs radically" from the fraudulent nondisclosure doctrine. *Chiarella*, 445 U.S. at 233.

332 *See* RESTATEMENT (SECOND) OF TORTS § 551 app. (1989).

333 *See supra* note 74.

334 "'Facts basic to the transaction' should not be equated with 'material facts' or 'facts important to the transaction.'" McNulty & Hanson, *supra* note 322, at 36. These terms, however, have been used interchangeably. *See, e.g.*, *supra* note 332.

are trading under a mistake that resulted from this nondisclosure, and (3) his counterparties reasonably expect the disclosure of this information because of other objective circumstances.[335]

To satisfy the first element, the information in insider trading must constitute a basic fact that goes to the essence of the transaction.[336] The *O'Hagan* Court recognized that O'Hagan's knowledge of the impending tender offer had been material, but was it *basic* to the securities transaction? One may argne that this fact was merely material rather than basic: Even if the trader knows what the price probably will be in the future, the current price—the essence of the insider trading transaction—still may be accurate. Moreover, the trader does not know for certain that the anticipated tender offer actually will take place.

Despite the timing and uncertainty of the tender offer, however, material information still may rise to the level of basic information, as the following hypothetical demonstrates. Suppose the value of a target share is $70 when the probability of a tender offer for the target company is negligible. Then suppose that a potential bidder prepares for a tender offer and plans to buy target shares at $100 each. Next, suppose that the attorney structuring the deal for the bidder trades on this information, and at the time of the trade he knows with about ninety percent probability that the tender offer will occur. When the attorney trades with target shareholders at $70 per share, he knows each share is worth approximately $97.[337]

Thus, the facts that the share will have a price of $100, that it will attain that price in the near future, and that at the time of trading it has about a ninety percent probability of rising to its future price, together constitute the basic fact that the market price grossly undervalues the share. In combination, these material facts rise to the level of

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335 *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(e) (1977).

336 *See id.* cmt. j.

337 The actual share value is the sum of (1) the expected price multiplied by the probability that the share will reach that price in the near future and (2) the current price multiplied by the probability of it remaining at that price (i.e., $97 = $100(90%) + $70(10%)).

According to the Efficient Market Hypothesis (EMH), "today's stock price is the best guess of tomorrow's stock price because current prices already reflect *all information* about the security." Angie Woo, Note, *Appraisal Rights in Mergers of Publicly-Held Delaware Corporations: Something Old, Something New, Something Borrowed, and Something B.L.U.E.*, 68 S. CAL. L. REV. 719, 734 n.71 (1995) (emphasis added) (citing RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 300 (4th ed. 1991)); *see also* H.R. REP. NO. 98-3555, at 2 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275 ("The prices of the vast majority of actively traded securities reflect available public information about companies and the economy.").

a basic fact because the high probability of the tender offer creates a disparity between actual and market value.[338]

This disparity between actual and market value and the fact that the insider trader capitalizes on this disparity satisfies the second element of section 551(2)(e). The disparity indicates that the public is unaware of the inside information. Had this information been disclosed to the public, market forces would have closed the gap between actual value and market price. Thus, when an individual knows this disparity exists and trades on it, he intentionally exploits the mistake of his public investor counterparties resulting from the nondisclosure of the basic information.[339]

The third element—that the counterparties expect reasonable disclosure—is slightly more problematic because of its open-ended nature.[340] The *Restatement (Second) of Torts*, however, suggests that the fact that an uninformed party reasonably could not expect to discover his ignorance is significant in determining section 551(2)(e) liability.[341] In insider trading, the party with superior knowledge trades on confidential business information. Consequently, the public cannot discover the insider's knowledge through reasonable investigation.[342] Another relevant factor is the uninformed party's reliance on the other party's good faith and honesty. In anonymous markets, reliance is difficult to prove.[343] In insider trading, however, many commentators regard investor confidence as essential to the securities market.[344] Thus, because the public relies on fair and honest markets, an uninformed investor reasonably would expect the disclosure of any basic

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338 This analysis is similar to what market analysts have termed the "mosaic theory." Brief of *Amicus Curiae* Association for Investment Management and Research in Support of Petitioner at 10, *O'Hagan*, 521 U.S. 642 (No. 96-842) (stating that the "mosaic theory" permits an analyst to "use a significant conclusion derived from perceptive analysis of public information and nonmaterial, nonpublic information as the basis of a securities recommendation or transaction . . . even if the conclusion derived would have constituted restricted material, nonpublic information had it been communicated directly to the analyst by an insider"). Whether the level of material facts always can rise to the level of basic facts in this manner is beyond the scope of this Note.

339 It seems that the possibility of confidential information may mean that the market contains a large number of "wrong" prices. However, every instance in which a trader profits from an undervalued stock does not constitute insider trading. Insider trading occurs only when the trader intentionally exploits inside information. One who profits without inside information is just fortunate.

340 *See* RESTATEMENT (SECOND) OF TORTS § 551 cmt. *l* (1977) (acknowledging that "[i]t is extremely difficult to be specific as to the factors that give rise to this known, and reasonable, expectation of disclosure").

341 *See id.* cmts. k, *l*, illus. 9-12.

342 This idea is similar to the access to information theory. *See supra* note 94 and accompanying text.

343 *See supra* note 62 and accompanying text.

344 "Insider trading threatens these markets by undermining the public's expectations of honest and fair securities markets where all participants play by the same rules." H.R. REP. No. 98-355, at 2 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2275.

fact regarding the price of a security. When an insider possesses information that is inaccessible to the public investor, the investor reasonably would expect that the securities laws would prohibit the insider from trading on that information.

The section 551(2)(e) approach is superior to the section 551(2)(a) approach and the misappropriation theory because it directly addresses the problem of insider trading. An individual who engages in insider trading possesses material, nonpublic information. This information almost always rises to the level of a basic fact that goes to the stock price—the essence of the transaction. Because this information is nonpublic, the trader knows that public investors do not have access to it. The trader also knows that because of the policy of maintaining open and honest markets, the public expects full disclosure of this information if the information assists in trading. Section 551(2)(a) reaches this exploitation of unfair informational advantage only if the trader is transacting with fiduciaries,[345] and the misappropriation theory reaches this conduct if this only breaches a duty to use of information by fiduciaries.[346] Section 551(2)(e) prohibits all transacting parties from exploiting unfair informational advantages.[347] The next Part proposes how insider trading law may assist in the application of the section 551(2)(e) doctrine.

VI
A PROPOSAL TO AID IN THE APPLICATION OF SECTION 551(2)(e)

Because the securities laws purport to maintain honest and open markets, it is reasonable for the public investor to believe that the laws compel everyone to play fairly in the market. This notion of fair play explains why the parity-of-information approach had been so appealing prior to *Chiarella*. The Supreme Court, however, chose other avenues to prohibit insider trading because of a disbelief that the actual language of the securities laws required such fairness. The Court proceeded conservatively in banning insider trading first by insiders[348] and then by their tippees.[349] After seventeen years of congressional inaction, the Supreme Court then controversially banned insider trading by breaching outsiders.[350]

Intuitively, insider trading law would be clearer if Congress had defined the problem rather than allowing the Court to attempt to im-

345 *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977).
346 *See* United States v. O'Hagan, 521 U.S. 642, 652 (1997).
347 *See* RESTATEMENT (SECOND) OF TORTS § 551(2)(e) (1977).
348 *See supra* Part II.A.
349 *See supra* Part II.B.
350 *See supra* Part III.

pose criminal liability with the catchall provision of section 10(b).[351] Congress, however, seems averse to defining "insider trading": "[E]vidence seems to show that any effort to define insider trading would result in, at best, a slightly less generalized rule than 10b-5 and, at worst, a rule that leaves gaping holes, previously referred to in hearings on the Code as 'large enough to drive a truck through.'"[352] Congress's unwillingness to draft a statute targeting the insider trading problem, the SEC's struggle to propose accepted rules and theories,[353] and the Court's failure to adopt an appropriate approach toward section 10(b) liability suggest that the solution may lie elsewhere.

If Congress, the SEC, or the courts were to persuade the securities exchanges to develop insider trading prohibition rules for their broker members, the exchanges then could establish a "custom of the trade" and thus allow the courts to apply section 10(b) to individuals through a section 551(2)(e) approach.[354] Professor Coffee has suggested that in the absence of congressional or SEC action, the best alternative for eliminating a loophole in existing insider trading theory is through the exchanges themselves—by self-regulatory organization (SRO) rules.[355] Professor Coffee noted that "SRO rules seem adequate to regulate broker dealers, but lack the deterrent threat necessary to stop 'true' insider traders, such as Mr. O'Hagan."[356] The section 551(2)(e) approach, however, mitigates this problem—rules that govern broker dealers may govern anyone who trades securities. If SRO rules can establish a "custom of the trade," the courts can determine that the insider trading of any individual constitutes a section 551(2)(e) fraud. The courts then can apply the antifraud provisions of section 10(b) and Rule 10b-5 to this fraud in connection with trading.

Encouraging exchanges to draft insider trading prohibition rules would not be difficult. Because exchanges typically profit from a high volume of trading, they strive to attract investors. Insider trading deters investors because "[i]nvestors are reluctant to play in what they

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351 *See supra* note 26 and accompanying text.

352 H.R. REP. No. 98-355, at 14 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2287.

353 The SEC was unable to persuade the Court to adopt either the fairness approach in *Chiarella* or its tippee liability theory in *Dirks*. The Supreme Court has not yet fully endorsed Rule 14e-3(a).

354 The author is indebted to Professor Richard Painter for this suggestion.

355 *See* Coffee, *supra* note 11. In addressing the problem of prohibiting trading when the source consents while distinguishing it from trading in the misappropriation context, Professor Coffee proposed that SRO rules could provide the solution: "The most feasible answer is SRO rules, which could be adopted by both the NASD and the stock exchanges and which could preclude member firms from trading on material, non-public information, even where the information had been voluntarily disclosed by the issuer." *Id.*

356 *Id.*

perceive to be a rigged game."[357] Consequently, creating insider trading prohibition rules is in the best interest of exchanges.

If insider trading law were to persuade the New York Stock Exchange (NYSE), for example, to design its own rules prohibiting insider trading, the NYSE could provide the Court with a solid section 551(2)(e) model. Suppose the NYSE promulgates a disclosure rule that requires a broker publicly to disclose any inside information prior to trading (with its securities expertise, the NYSE could define adequately "inside information"). This rule firmly would establish a custom of the trade, which the courts could apply to insiders or outsiders (brokers or not), in instances in which a public investor "would reasonably expect a disclosure."

CONCLUSION

To be sure, this Note's proposal of a *Restatement (Second) of Torts* § 551(2)(e) framework does not signify a significant departure from the pre-*Chiarella* fairness approach. Rather, this Note argues that section 551(2)(e) provides a justification for the fairness approach which the Court was unable to discover. Although existing theory after the Supreme Court's adoption of the misappropriation theory in *O'Hagan* prohibits most insider trading once covered by the fairness approach, significant loopholes persist. Because section 551(2)(e) permits it, insider trading law can re-adopt this fairness approach rather than endure numerous, narrow, fiduciary-based theories attempting to achieve the fairness by indirect means. The misappropriation theory restricts the traitor for who he knows. The fairness approach restricts the trader for what he knows.

Admittedly the fairness approach is not flawless and, if adopted, should not constitute the last step in the development of insider trading prohibition. Indeed, it may chill benign and even desirable conduct given the intricate problems involved in tippee trading.[358]

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357 Pritchard, *supra* note 12, at 49.

358 This blanket prohibition of the fairness approach may hinder securities analysts from carrying out their duties. *See supra* notes 144-47 and accompanying text. However, there is some indication that this problem is not as serious as the Court perceived. *See* Dalley, *supra* note 12, at 1325 ("There is no reason to tailor insider trading regulation to specifically deal with the analyst problem.").

The fairness approach may also punish traders who have unwittingly eavesdropped on the communication of inside information. *See* SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (holding that the fiduciary-based framework of post-*Chiarella* insider trading law does not reach trading tippees who had no reason to know that the tipper had breached a fiduciary duty to the transacting shareholders). The courts have been unwilling to extend securities law to traders who stumble upon inside information.

The applicability of the fairness approach, in particular the basic facts doctrine, to insider trading is questionable when the tippee himself lacks information of the security he trades. Suppose a tipper tells a tippee to buy stock *X*. When the tippee asks, "Why?", the tipper responds, "Just trust me," instead of offering any basic information like, "Because

However, the law can carve out exceptions to an overinclusive rule[359] and the fairness approach represents a good starting point as it did almost forty years ago.

The law must prevent insider trading because it threatens market integrity and fairness, not because it threatens fiduciary relationships. Insider trading is like playing cards with a marked deck.[360] No one cares whether one has stolen the deck from his friend, just that he is playing with it. Properly drafted SRO insider trading prohibition rules would enable the enforcement of section 10(b) through section 551(2)(e). By creating house rules that call for the disclosure of marked cards, the game can establish a custom that prevents the exploitation of innocent players before the deal.

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the stock will split in the next few days." It is unclear whether courts could determine that the tippee's knowledge of the tipper's access to certain information in conjunction with the recommendation amounts to a basic fact that must be disclosed.

359 After all, insider trading law has endured the overinclusiveness of section 16—the original insider trading provision. *See supra* notes 28-30 and accompanying text.

360 *See* LOSS & SELIGMAN, *supra* note 1, at 930.