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Introduction

In *United States v. O'Hagan*,[1] the United States Supreme Court held that a person who trades in securities for personal profit, using confidential information misappropriated in breach of a fiduciary duty to the source of the information, may be held liable for violating section 10(b) and Rule 10b-5.[2] Before *O'Hagan*, the Court had limited the reach of section 10(b) of the Securities and Exchange Act of 1934[3] to the text of the statute, rather than expand it for policy reasons.[4] On June 25, 1997, however, the Court looked beyond the plain language of section 10(b) and decided that the misappropriation theory[5] would properly serve the underlying purpose

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1. 117 S. Ct. 2199 (1997).

2. *See id.* at 2207, 2214. Section 10(b) provides:

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

15 U.S.C. § 78j (1997).

Rule 10b-5 makes it unlawful for:

> any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or 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.

17 C.F.R. § 240.10b-5 (1998).

3. 15 U.S.C. § 78a-78ll (1997).

4. *See infra* Part II.B.

5. *See O'Hagan*, 117 S. Ct. at 2207. Under the misappropriation theory, a person commits fraud "in connection with" a securities transaction, and therefore violates section 10(b) and Rule 10b-5, when he misappropriates confidential information for

of the securities laws.[6] This policy-based decision shocked and disappointed the many commentators awaiting the Supreme Court's resolution of this matter.[7]

Critics of the misappropriation theory argue that stretching criminal liability under section 10(b) and Rule 10b-5 is not the appropriate way of criminalizing this type of unlawful insider trading.[8] Instead, Congress should enact a statute which explicitly prohibits insider trading and trading on misappropriated information in breach of a fiduciary duty.[9] Until the legislature acts, however, section 10(b) should be construed narrowly to ensure consistency and fairness.[10]

This Note argues that the misappropriation theory is inconsistent with the language of section 10(b) and Supreme Court precedent, and provides no guidance for lower courts regarding the application of liability under section 10(b) and Rule 10b-5. By holding that "a fiduciary's undisclosed, self-serving use of a principal's in-

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use in the securities market, in breach of a duty owed to the source of the information. *See id.*

6. *See id.* at 2210 ("The misappropriation theory comports with § 10(b)'s language . . . [and] is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."). The Court also held that the Securities and Exchange Commission did not exceed its rulemaking authority in promulgating Rule 14e-3(a), but an analysis of that decision is beyond the scope of this Note. *See id.* at 2214.

7. *See* Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1158-59 (1997) (noting that the Supreme Court's endorsement of the misappropriation theory "surprises many commentators, given the Court's twenty-year history of making securities fraud litigation more restrictive."); Edward Felsenthal, *Big Weapon Against Insider Trading Is Upheld*, WALL ST. J., June 26, 1997, at C1 ("The O'Hagan ruling came as a surprise to many lawyers who had predicted the mostly conservative court would balk at reading the law expansively.").

8. *See, e.g.*, Joseph A. Grundfest, *We Must Never Forget That It is an Inkblot We are Expounding: Section 10(b) as Rorschach Test*, 29 LOY. L.A. L. REV. 41, 43 (1995) (arguing that when a statute is vague, "any attempt to fashion a broader interpretation inevitably relies on the subjective and unguided preference of the judiciary rather than the articulated guidance of the elected legislature."). *Cf.* Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 121 (1984) ("The theory that one who misappropriates confidential information deceives the person who entrusted the information to him, and that his trading on the information causes damage to other investors, provides a generalized explanation of why trading on nonpublic information in an impersonal market may violate Rule 10b-5.").

9. *See infra* notes 189-90 and accompanying text.

10. *See* Grundfest, *supra* note 8, at 44 (arguing that the misappropriation theory is likely to lead to inconsistent results because "[r]easonable minds can differ as to the import of . . . section 10(b). . . , and honorable Justices strongly opposed to fraud in the nation's securities markets can legitimately oppose limitless extensions of section 10(b)'s cryptic language.").

formation to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal" and violates section 10(b),[11] the Court left many questions unanswered. Lower courts must now grapple with the extent to which liability can be imposed, the types of trust relationships sufficient to give rise to liability when a breach occurs, and the level of "connection" that is required between the fraud and the purchase or sale of securities.

This Note examines the development of the misappropriation theory and argues that its adoption by the Supreme Court in *O'Hagan* was erroneous because it cannot be reconciled with the language of section 10(b) or previous Supreme Court decisions, which strictly interpreted the text of the statute. Part I provides the background and legislative intent behind section 10(b), discusses insider trading and the misappropriation theory, and examines how the lower courts have attempted to reconcile the misappropriation theory with the language of section 10(b) and Rule 10b-5. Part II presents canons of statutory construction and the Supreme Court's section 10(b) jurisprudence, focusing on the *O'Hagan* case. Part III analyzes the misappropriation theory and concludes that the Court's use of policy in interpreting the statute, rather than the plain language of section 10(b), was improper because courts are not competent to make law in the securities markets and should instead defer this responsibility to Congress.

I. Section 10(b), Rule 10b-5, and the Prohibition of Unlawful Trading

While the federal securities laws do not expressly prohibit insider trading, the doctrine has evolved from Securities and Exchange Commission ("SEC") and judicial interpretations of the general antifraud provisions of the federal securities laws,[12] in particular, section 10(b) and Rule 10b-5.[13]

11. United States v. O'Hagan, 117 S. Ct. 2199, 2207 (1997).

12. *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 184-85 (1991).

13. *See* Moss v. Morgan Stanley Inc., 719 F.2d 5, 10 (1983) ("It is well settled that traditional corporate 'insiders' – directors, officers and persons who have access to confidential corporate information – must preserve the confidentiality of nonpublic information that belongs to and emanates from the corporation.") (internal citations omitted).

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

After the stock market crash in 1929, and the depressed economy that followed, Congress enacted the Securities Act of 1933[14] ("1933 Act") and the Securities and Exchange Act of 1934[15] ("1934 Act") to regulate the troubled securities market.[16] The purpose of the 1933 Act was to encourage full disclosure of information regarding public offerings of securities, to protect investors against fraud, and to promote ethical standards of honesty and fair dealing.[17] Through the regulation of securities transactions, the 1934 Act was designed to protect investors against the manipulation of stock prices, and to impose regular reporting requirements on companies with stock listed on national securities exchanges.[18]

Pursuant to the 1934 Act, Congress created the SEC and equipped it with flexible enforcement powers to accomplish the statute's goals.[19] Section 10(b) of the 1934 Act, which was designed as a catch-all clause to prevent fraudulent practices,[20]

14. 15 U.S.C. § 77a-77aa (1997).

15. 15 U.S.C. § 78a-78ll (1997).

16. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976); *see also* Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 407-08 (1990) ("[T]he central inspiration for the Act was the combination of the bull market of the 1920s and the dramatic collapse that ended it."); Timothy J. Horman, Comment, *In Defense of United States v. Bryan: Why the Misappropriation Theory is Indefensible*, 64 FORDHAM L. REV. 2455, 2457 (1996) ("Insider trading was one of the major abuses that Congress perceived as a cause of the 1929 crash.").

17. *See Ernst & Ernst*, 425 U.S. at 195.

18. *See id.* Senator Fletcher, who was the sponsor of the 1934 Act and the Chairman of the Senate Committee on Banking and Currency at the time, explained the Act's purpose:

> Manipulators who have in the past had a comparatively free hand to befuddle and fool the public and to extract from the public millions of dollars through stock-exchange operations are to be curbed and deprived of the opportunity to grow fat on the savings of the average man and woman of America. Under this bill the securities exchanges will not only have the appearance of an open market place for investors but will be truly open to them, free from the hectic operations and dangerous practices which in the past have enabled a handful of men to operate with stacked cards against the general body of the outside investors. For example, besides forbidding fraudulent practices and unwholesome manipulations by professional market operators, the bill seeks to deprive corporate directors, corporate officers, and other corporate insiders of the opportunity to play the stocks of their companies against the interests of the stockholders of their companies.

78 CONG. REC. 2271 (1934) (statement of Sen. Fletcher), *quoted in* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 765 (1975).

19. *See Ernst & Ernst*, 425 U.S. at 195.

20. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980). Notably, one of the drafters of the provision indicated:

empowers the SEC to make rules and regulations prohibiting the use of any manipulative or deceptive device in connection with the purchase or sale of any security.[21] The SEC promulgated Rule 10b-5 in 1942, pursuant to a grant of authority under section 10(b).[22] Rule 10b-5 makes it unlawful for any person to "employ any device, scheme, or artifice to defraud," or to engage in any act which operates as a "fraud or deceit . . . in connection with the purchase or sale of any security."[23]

B. Insider Trading: The Traditional Theory

The traditional theory of insider trading liability provides that Rule 10b-5 is violated when a person buys or sells securities based on nonpublic information if:

> (1) he owes a fiduciary or similar duty to the other party to the transaction; (2) he is an insider of the corporation in whose shares he trades, and thus owes a fiduciary duty to the corporation's shareholders; or (3) he is a tippee who received his information from an insider of the corporation and knows, or should know, that the insider breached a fiduciary duty in disclosing the information to him.[24]

The failure to disclose material information when under a fiduciary duty to do so, prior to trading, is a fraudulent omission, implicating liability under section 10(b) and Rule 10b-5 because these provisions explicitly prohibit deception and fraud in securities transac-

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> Of course subsection (c) [section 9(c) of H.R. 7852 – later section 10(b)] is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.

Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934), *quoted in Ernst & Ernst*, 425 U.S. at 202-03.

21. *See Chiarella*, 445 U.S. at 225. Section 10(b) provides that it is unlawful to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance *in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors*." 15 U.S.C. § 78j(b) (1997) (emphasis added).

22. *See Chiarella*, 445 U.S. at 225.

23. 17 C.F.R. § 240.10b-5 (1998).

24. Aldave, *supra* note 8, at 101-02. One commits Rule 10b-5 fraud only if he or she "fails to disclose material information prior to the consummation of a transaction . . . when he [or she] is under a duty to do so." *Chiarella*, 445 U.S. at 228. This duty "does not arise from the mere possession of nonpublic market information," but rather arises from "a fiduciary or other similar relation of trust and confidence" between the parties to the transaction. *Id.* at 235, 228.

tions.[25] Thus, the breach of the insider's duty to the shareholders constitutes the "deceptive device" required by the traditional theory of liability under section 10(b).[26]

In 1961, in the seminal case of *In re Cady, Roberts & Co.*,[27] the SEC decided that a corporate insider must abstain from trading shares of the corporation for which he works, unless he has first disclosed all the material, inside information.[28] The SEC noted that the obligation to disclose stems, first, from the existence of a relationship giving access to information intended to be available only for a corporate purpose, and second, from the inherent unfairness that exists when a party takes advantage of such information.[29] This case essentially created the "disclose or abstain" requirement[30] which the Supreme Court subsequently followed.[31]

In *Chiarella v. United States*,[32] the Supreme Court endorsed insider trading liability. The Court decided that a person who had access to confidential documents, and used this information to buy the stock of companies that were about to become targets of takeover bids, could be liable for violating section 10(b) if they failed to disclose the information prior to trading.[33] The defendant in *Chiarella*, however, was a "complete stranger" to the transaction because he worked for a financial printer and owed no fiduciary duty to the shareholders of the target companies.[34] The Court held that the failure to disclose material information prior to the consummation of a transaction constitutes fraud only when a duty to

25. *See Chiarella*, 445 U.S. at 230 (noting that "administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)").

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

27. 40 S.E.C. 907 (1961).

28. *See id.* at 911. In *Cady, Roberts*, the Board of Curtiss-Wright met to discuss, among other things, the reduction of a quarterly dividend. *See id.* at 909. Upon approving the reduction, the board authorized transmission of the information to the New York Stock Exchange. *See id.* However, there was a problem with the transmission which led to a delay of the announcement on the Dow Jones ticker tape. *See id.* During a recess in the board meeting after the dividend decision was made, one of the directors, J. Cheever Cowdin, contacted a selling broker and informed him of the dividend cut. *See id.* The broker entered sell orders, and traded shares of the Curtiss-Wright stock before the dividend announcement appeared on the Dow Jones tape. *See id.*

29. *See id.* at 912.

30. *See Chiarella*, 445 U.S. at 227.

31. *See, e.g.*, Dirks v. SEC, 463 U.S. 646, 653-54 (1983); *Chiarella*, 445 U.S. at 227.

32. 445 U.S. 222 (1980).

33. *See id.* at 224, 230.

34. *See id.* at 224, 232-33.

disclose exists.[35] Such a duty arises, according to the Court, "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.'"[36] Because the lower courts failed to identify a relationship that could give rise to such a duty, the Court reversed the conviction in *Chiarella*.[37]

Liability under the classical theory of insider trading is based upon the fraud that is committed when a corporate insider trades on nonpublic information, without prior disclosure, in breach of a duty to the corporation.[38] Several years after its *Chiarella* decision, the Supreme Court addressed the scope of liability under the classical theory in *Dirks v. SEC*.[39] There, the Court held that a tippee is liable for fraud when he knows or should have known that the tip he received constituted a breach of the insider's fiduciary duty to the shareholders of a corporation.[40] Dirks, a securities analyst, obtained information about a fraud within an insurance company from a former officer of the company.[41] Upon investigating and confirming the allegations, Dirks discussed this information with

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35. *See id.* at 228.

36. *Id.* (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a)(1976)).

37. *See id.* at 231-32. In its brief to the Court, the United States argued in the alternative that Chiarella should be convicted under the misappropriation theory. *See id.* at 235-36. The Court did not reject this argument, but noted that "[w]e need not decide whether this theory has merit for it was not submitted to the jury." *Id.* at 236. Chief Justice Burger, on the other hand, strongly objected to reversing Chiarella's convictions.

> [T]he evidence shows beyond all doubt that Chiarella, working literally in the shadows of the warning signs in the printshop, misappropriated – stole to put it bluntly – valuable nonpublic information entrusted to him in the utmost confidence. He then exploited his ill-gotten informational advantage by purchasing securities in the market. In my view, such conduct plainly violates section 10(b) and Rule 10b-5.

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

38. *See, e.g.*, David M. Brodsky & David J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, SB93 ALI-ABA 105, 108 (1997)

> Traditionally, the duty not to trade securities on the basis of material, nonpublic information concerning the issuer was premised upon the common law duty owed by a director, officer, or controlling shareholder of a corporation to the corporation's shareholders not to gain a personal advantage through the use of nonpublic information concerning the corporation's securities. Absent such a special relationship between the "insider" and the shareholders, there was no duty to disclose the information or abstain from trading while in possession of inside information.

Id.; *see also* Fisch, *supra* note 12 at 187-90.

39. 463 U.S. 646 (1983).

40. *See id.* at 661-62.

41. *See id.* at 648-49.

clients and investors.[42] The Court, however, found that no breach occurred because the insider did not personally benefit from his disclosure.[43]

C. The Misappropriation Theory

The misappropriation theory is another way courts have applied insider trading liability pursuant to section 10(b) and Rule 10b-5. Although liability under the traditional theory tends to be limited to corporate insiders and tippees, liability pursuant to the misappropriation theory has been extended to outsiders who would not ordinarily be considered fiduciaries of the corporation in whose stocks they trade.[44] Such outsiders include lawyers, stockbrokers, financial printers, newspaper reporters, family members, and psychiatrists.[45]

Under the misappropriation theory, section 10(b) and Rule 10b-5 are violated when a person misappropriates material, nonpublic information by breaching a duty which arises out of a relationship of trust and confidence, and uses that information in a securities transaction, regardless of whether he owes any duty to the shareholders of the traded stock.[46] Liability is based upon the principle that it is unfair to trade securities using information that was im-

42. *See id.* at 649. The SEC learned of the fraud after the stock price fell from $26 per share to less than $15, prompting their own investigation. *See id.* at 650. The SEC found that the analyst had aided and abetted violations of the securities laws, including section 10(b). *See id.*

43. *See id.* at 667. The *Dirks* Court, applying the *Cady, Roberts* analysis, recognized that the two elements for establishing a Rule 10b-5 violation are: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Id.* at 653-54 (citations omitted). Although Dirks' exposure of the insurance company's fraud led to the liquidation of more than $16 million invested in the company, because the tipper acted in order to expose the fraud, and not to benefit personally, he breached no fiduciary duty, and therefore Dirks could not be held derivatively liable. Further, there was no expectation by Dirks' sources that he would keep their information in confidence, and Dirks did not misappropriate the information. *See id.* at 665.

44. *See* SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991) (holding that the defendant, who misappropriated and traded upon material information he acquired at a bank where he was previously employed, violated section 10(b) and Rule 10b-5 pursuant to the misappropriation theory).

45. *See* United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995) (discussing the diverse relationships the misappropriation theory has been applied to in other courts, but ultimately rejecting the argument that convictions for securities fraud under section 10(b) and Rule 10b-5 could rest on the misappropriation theory).

46. *See* SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990) (holding an employee liable for misappropriating nonpublic information regarding his employer's plan to acquire another company).

properly acquired or not intended to be used for personal gain.[47] The focus, therefore, is on whether the insider breached a fiduciary duty to any lawful possessor of nonpublic information, rather than to the issuing company or its shareholders.[48]

Moreover, unlike liability imposed under the traditional theory of insider trading, the misappropriation theory reaches persons who are neither insiders of the companies whose shares are being traded, nor tippees of such insiders.[49] In fact, the misappropriation theory does not even require that the buyer or seller of the securities be defrauded.[50] Instead, the victim of the "deceptive device" under section 10(b) must be a party to which the offending trader owed a fiduciary duty.[51] "Deception through nondisclosure" to that party is what creates liability under the misappropriation theory.[52]

The Supreme Court first discussed liability for misappropriating information in Chief Justice Burger's *Chiarella*[53] dissent when he opined that, pursuant to section 10(b) and Rule 10b-5, "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[54] While the Chief Justice conceded that there generally is no duty to disclose unless the parties are in a fiduciary relationship, he argued that a duty arises when unlawful means are used to gain an informational advantage, and that the failure to disclose thus constitutes fraud.[55]

1. Reconciling the Misappropriation Theory with Section 10(b) and Rule 10b-5

The underlying principle of the misappropriation theory is the extension of section 10(b) liability to outsiders who unlawfully ben-

47. *See* Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 144 (1995) ("The emotional impulse that vibrates the misappropriation theory seems to be a visceral dislike for asymmetric market information, especially if a person unfairly obtains such information.").

48. *See Cherif*, 933 F.2d at 409.

49. *See* Aldave, *supra* note 8, at 111-12.

50. *See* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc).

51. *See Cherif*, 933 F.2d at 409.

52. *See, e.g.*, United States v. O'Hagan, 117 S. Ct. 2199, 2209 (1997) (explaining that full disclosure forecloses liability under the misappropriation theory, because with disclosure, "there is no 'deceptive device' and thus no § 10(b) violation").

53. 445 U.S. 222 (1980).

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

55. *See id.* at 239-40.

efit from material, nonpublic information, in order to protect the source of misappropriated information, rather than the market participants.[56] Because the misappropriation theory is a source of liability pursuant to section 10(b) and Rule 10b-5, the prohibited conduct must consist of fraud in connection with the purchase or sale of securities.[57]

a. The Fraud Requirement

The Second Circuit Court of Appeals was the first court to apply the misappropriation theory, in *United States v. Newman*,[58] when it held that a securities trader may be held criminally liable for trading on a tip conveyed to him by two employees who misappropriated the information from their investment banking firms.[59] Although the employees owed no duty to the company whose shares they traded, the court found the breach of fiduciary duty to their employer was enough to support a Rule 10b-5 conviction.[60] Despite the Supreme Court's holding that not every instance of fraud violates section 10(b) or Rule 10b-5,[61] the *Newman* court held that the mere breach of an employment relationship was adequate.[62] Beginning with this important decision, the Second Circuit helped develop the misappropriation theory, applying it to a variety of situations where there was some breach of trust and confidence.[63]

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56. *See* United States v. Bryan, 58 F.3d 933, 944 (1995); United States v. Chestman, 947 F.2d 551, 567 (2d Cir. 1991) (en banc). *Cf. O'Hagan*, 117 S. Ct. at 2207 ("The misappropriation theory is thus designed to 'protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation'").

57. *See* 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

58. 664 F.2d 12 (2d Cir. 1981).

59. *See id.* at 16.

60. *See id.* at 17. The *Newman* court noted that it "need spend little time on the issue of fraud and deceit" and went on to explain that "[b]y sullying the reputations" of the investment banking firms, Newman and his cohorts "defrauded those employers as surely as if they took their money." *Id.*

61. *See* Chiarella v. United States, 445 U.S. 222, 232 (1980) ("[N]ot every instance of financial unfairness constitutes fraudulent activity under § 10(b)."); Santa Fe Indus. v. Green, 430 U.S. 462, 472-73 (1977) (holding that section 10(b) violations must be based on manipulation or deception).

62. *See Newman*, 664 F.2d at 17.

63. *See generally*, United States v. Bryan, 58 F.3d 933, 953-59 (1995). In *Moss v. Morgan Stanley*, 719 F.2d 5 (2d Cir. 1983), which involved the same defendants and arose out of the same conduct that gave rise to the criminal convictions in *Newman* but was brought by a target corporation shareholder, the court noted that "[n]othing in our opinion in *Newman* suggests that an employee's duty to 'abstain or disclose' with respect to his employer should be stretched to encompass an employee's 'duty of disclosure' to the general public." *Id.* at 13. In construing *Chiarella*, the court found that section 10(b) liability could not be predicated on the misappropriation of confi-

Courts applying the misappropriation theory easily found the section 10(b) fraud requirement fulfilled where there was a breach of duty to an employer,[64] but have extended the theory far beyond the employment context. For example, in *United States v. Willis*,[65] a psychiatrist's use of information revealed by a patient was found to be a sufficient basis for section 10(b) liability.[66] In addition, the

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dential information without the breach of a fiduciary duty. *See id.* at 12. Later, in *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), the court addressed facts similar to those in *Chiarella*, namely, that an employee at a financial printing firm learned the identity of tender offer targets in the course of his employment and traded on such information. *Id.* at 199. The court found Materia liable, holding that "one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates section 10(b) and Rule 10b-5." *Id.* at 203. Materia breached the duty he owed to his employer, thereby implicating the misappropriation theory, whereas the Moss court ruled that such a breach was insufficient to give rise to section 10(b) liability. *See Moss*, 719 F.2d at 13. The court reconciled *Materia* and *Moss* by distinguishing between a criminal action and a private action for damages. *See Materia*, 745 F.2d at 203.

The Second Circuit took the misappropriation theory even further in its decision in *United States v. Carpenter*, when it held that Rule 10b-5 was violated when a newspaper columnist from the *Wall Street Journal* misappropriated securities-related information that was scheduled to appear in the "Heard on the Street" column and traded upon information contained in these upcoming columns. *See Carpenter*, 791 F.2d 1024, 1026-27, 1034 (2d Cir. 1986). The court explained that while *Dirks* held that certain trading by insiders or quasi-insiders violated Rule 10b-5, that is not to say that other forms of misconduct do not implicate the Rule. *See id.* at 1029. Namely, the court established that the predicate act of fraud may be committed on the source of the nonpublic information, even though the source may be unaffiliated with the buyer or seller of securities. *See id.* at 1032. The Supreme Court granted *certiorari* and an equally divided Court affirmed the conviction without an opinion. *See* Carpenter v. United States, 484 U.S. 19, 24 (1987).

64. *See, e.g., supra* note 60 and accompanying text. *See also* SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990) ("We find no linguistic reason not to apply this conception of fraud to the securities context. . . . [and] conclude that the misappropriation theory fits comfortably within the meaning of 'fraud' in § 10(b) and Rule 10b-5.").

65. 737 F. Supp. 269 (S.D.N.Y. 1990) (denying a motion to dismiss an indictment charging Dr. Willis, a psychiatrist, of violating section 10(b) and Rule 10b-5 by purchasing securities based on business information confided in him by a patient for his diagnosis and treatment).

66. *See id.* at 274-75. Dr. Willis' patient was the wife of a corporate executive who confided in him about her husband's efforts to become CEO of BankAmerica. *See id.* at 271. Finding it "difficult to imagine a relationship that requires a higher degree of trust and confidence than the traditional relationship of physician and patient," the court held that, if proven, the allegations could subject Willis to the misappropriation theory of securities fraud. *Id.* at 272, 275. The court reasoned that by holding himself out "as her physician with recognized obligations of confidentiality for his patient's secrets," and failing to advise her of his intent to profit on this confidential information, Willis fraudulently induced her to confide in him in connection with his securities trading. *Id.* at 274. The court further found that the patient had a property interest in her psychiatric treatment, and by jeopardizing their relationship of trust and confidence, Willis put at risk the patient's financial investment in the treatment. *Id.*

misappropriation theory was extended to the family relationship in *United States v. Reed*,[67] where the court held that a son's breach of his father's trust may give rise to liability under section 10(b).[68]

While the expansion of liability under the misappropriation theory in the Second Circuit was significant, courts did not find the requisite fraud in every section 10(b) case. In *United States v. Chestman*,[69] for example, the breach of confidence between a husband and wife was not sufficient to impose liability.[70] The court went to great lengths analyzing what constitutes a fiduciary relationship and its equivalent, noting that it must be cautious in extending the misappropriation theory to new relationships.[71]

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67. 601 F. Supp. 685 (S.D.N.Y. 1985).

68. *See id.* at 705. The court held that:

> A person who receives confidential information from another and misappropriates it for personal benefit is deemed to hold the proceeds of the misappropriation in a constructive trust for the benefit of the entrusting party. The misappropriator thus becomes the *trustee ex maleficio*, or quasi-fiduciary, of the entrustor. In the context of the securities laws, it does not matter for purposes of assessing liability whether the recipient of the information is actually trading in the securities issued by the source of the information. Rather, the duty is breached by the misappropriation and resulting profit, and a constructive trust attaches.

Id. at 700 (citations omitted).

69. 947 F.2d 551 (2d Cir. 1991) (en banc).

70. *See id.* at 571. Keith Loeb, the husband of a member of the Waldbaum family, was told by his wife that the company was being sold and was cautioned not to tell anyone so as not to risk ruining the sale. *See id* at 555. However, Loeb told his stockbroker, Chestman, who traded on that information, knowing of Loeb's relation to the Waldbaum corporation. *See id.* In the *Chestman* opinion, the court recognized that it broke ranks with its *Carpenter* decision, since it was the first fact pattern it considered that "is clearly beyond the pale of the traditional theory of insider trading." *Id.* at 566-67. In the end, the court concluded that there was not enough evidence to establish a fiduciary relationship or a similar relationship of trust and confidence between Loeb and the Waldbaum family, and therefore held that he did not defraud them by disclosing the information to Chestman. *See id.* at 570-71. Because Loeb had committed no fraud, Chestman could not be held derivatively liable as Loeb's tippee or as an aider and abettor under the misappropriation theory. *See id.* at 571.

71. *See id.* at 567-71. In evaluating what constitutes a fiduciary relationship, the *Chestman* court looked first to associations that the common law has recognized as inherently fiduciary:

> Counted among these hornbook fiduciary relations are those existing between attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, and senior corporate official and shareholder.

Id. at 568. Noting that this is not an exhaustive list, the court held that a breach of a similar relationship of trust and confidence, which must share the same qualities of a fiduciary relationship, also implicates the misappropriation theory. *See id.* at 658. Analyzing the characteristics of a fiduciary relationship, the *Chestman* court found that "'at the heart of the fiduciary relationship' lies 'reliance, and de facto control and *b. The "In Connection With" Requirement*

Not only must fraud exist for the misappropriation theory to apply, but the fraud must be "in connection with" the purchase or sale of securities.[72] When the Supreme Court addressed this issue with respect to traditional insider trading, it rejected the notion that every fraud or breach of fiduciary duty by a corporate insider to shareholders constituted securities fraud.[73] Nevertheless, when discussing this element in *United States v. Newman*,[74] the Second Circuit easily found satisfied the "in connection with" requirement of Rule 10b-5 because Newman's fraud "touched" the securities transaction.[75] Generally, once courts identify fraud sufficient to give rise to section 10(b) liability, they also find the "in connection with" requirement satisfied due to the self-evident nexus that exists between the two components in these cases.[76]

Although the Second Circuit has the most experience interpreting section 10(b) and Rule 10b-5, other circuits have addressed the issue of whether the misappropriation theory is consistent with the statute.[77] By the time the issue reached the Supreme Court, the Fourth and Eighth Circuits had held that criminal liability under section 10(b) may not be predicated on the misappropriation the-

dominance.'" *Id.* (quoting United States v. Margiotta, 688 F.2d 108, 125 (2d Cir. 1982).

72. *See, e.g.*, SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990) ("Section 10(b) and Rule 10b-5 do not proscribe all frauds occurring in the business world, but only those 'in connection with the purchase or sale of any security.' In other words, the fraud must somehow 'touch' upon securities transactions.").

73. *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737-38 (1975) (holding that defrauded investors who did not trade because of a misrepresentation do not have standing to bring a private damage action under Rule 10b-5).

74. 664 F.2d 12 (2d Cir. 1981).

75. *See id.* at 18 (citing Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)). The *Newman* Court improperly characterized the "purchaser or sellers" portion of the text as a mere standing requirement. *See id.* at 17.

76. *See, e.g.*, *Clark*, 915 F.2d at 449 ("Purely as a matter of linguistic construction, we have little trouble concluding that there is" some nexus between the misappropriation and the subsequent trading); United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986). *See also* SEC v. Cherif, 933 F.2d 403, 410 (7th Cir. 1991) ("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"); SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984) (finding the suggestion that the fraud was not "in connection with" the purchase or sale of securities is "inimical to the letter and spirit of the expansive scheme created to combat fraud in the securities markets. The information Materia stole has no value whatsoever except 'in connection with' his subsequent purchase of securities.").

77. *See, e.g.*, United States v. O'Hagan, 92 F.3d 612, 615 (8th Cir. 1996); United States v. Bryan, 58 F.3d 933, 943 (4th Cir. 1995); *Cherif*, 933 F.2d at 408; *Clark*, 915 F.2d at 442; Rothberg v. Rosenbloom, 771 F.2d 818, 822 (3d Cir. 1985).

ory,[78] while the Second, Seventh, and Ninth Circuits held that it could.[79]

II. Interpreting Section 10(b)

Statutes are typically written in general terms because they are invariably products of political compromise.[80] As a result, it is often up to the judiciary to determine the legislative intent and meaning of statutes in a particular case.[81] Principles of statutory interpretation fix the limits of a statute's reach, and thus the outcome of a particular decision depends a great deal upon which canon of statutory interpretation a court employs.[82]

A. Canons of Construction

When courts look to a statute to determine the scope of liability, they often use tools of statutory interpretation and construction to ascertain the meaning of the language.[83] The four main schools of statutory interpretation are: textualism, intentionalism, purposivism, and the dynamic theory.[84] While the Supreme Court has almost consistently interpreted section 10(b) using a textual or plain language approach,[85] the other canons of construction are also acceptable methods of interpreting statutes.[86]

1. *Textualism*

Textualism requires courts to rely strictly on the language of a statute to ascertain its meaning.[87] Proponents of this method con-

78. *See O'Hagan*, 92 F.3d at 617; *Bryan*, 58 F.3d at 944.

79. *See* United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991); *Cherif*, 933 F.2d at 410; *Clark*, 915 F.2d at 453. The Third Circuit has also seemingly adopted the misappropriation theory. *See Rothberg*, 771 F.2d at 822 (finding that one "violates the insider trading rule when he uses insider information in violation of the fiduciary duty owed to the corporation to which hew owes a duty of confidentiality.").

80. *See* Kenny & Thebaut, *supra* note 47, at 140.

81. *See id.*

82. *See* Steven A. Meetre, *Textualist Statutory Interpretation Kills Section 10(b) "Aiding and Abetting" Liability*, 63 DEF. COUNS. J. 58, 60 (1996) ("Often it is a court's interpretation of the [statute's] language that determines the application and effect of legislation.").

83. *See id.*

84. *See* WILLIAM N. ESKRIDGE, JR., DYNAMIC STATUTORY INTERPRETATION 10 (Harvard University Press ed. 1994). These statutory tools are not mutually exclusive.

85. *See infra* Part II.B.

86. *See* ESKRIDGE, *supra* note 84, at 14.

87. *See* Karen M. Gebbia-Pinetti, *Statutory Interpretation, Democratic Legitimacy and Legal-System Values*, 21 SETON HALL LEGIS. J. 233, 237 (1997) ("'Textualists' contend that the only democratically legitimate source of meaning is the actual statu-

tend that the plain meaning of the text is a reasonable indication of the legislature's intent.[88] This approach requires a court interpreting a statute to confine itself to a literal reading of the text, unless the text is ambiguous on its face, or such a reading would lead to an "absurd" or "bizarre" result.[89]

Critics of the plain language approach to interpreting section 10(b), like Melvin Aron Eisenberg, argue that the approach is intellectually incoherent because of the difficulty in identifying canonical statutory text.[90] Eisenberg explains that strict textualists do not necessarily confine the canonical text to the statutory provisions at issue and, as a result, widen the text to include the entire law or even all statutes adopted by the relevant legislature.[91] Moreover, even if strict textualism were coherent, Eisenberg argues that judges have an obligation to be faithful servants of the legislature, and using this methodology violates the obligation.[92]

Despite these criticisms, most courts rely on textualism in interpreting section 10(b).[93] In addition, the Supreme Court generally interprets all statutes based upon their plain meaning.[94] The Supreme Court has emphasized that where the language of the statute is plain, the sole function of a court is to enforce a statute according to its terms.[95] Although the legislative history of a stat-

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tory text, not any underlying ideas, intentions or purposes that have not cleared the hurdles of democratic lawmaking."); Meetre, *supra* note 82, at 60 (1996).

88. *See* Meetre, *supra* note 82, at 60.

89. *See* Melvin Aron Eisenberg, *Strict Textualism*, 29 LOY. L.A. L. REV. 13 (1995).

90. *See id.* at 14, 22.

91. *See id.* at 22-23. Eisenberg explains that because the particular provision at issue is often part of a larger statute, or is in a statute that is one of a group of related statutes, "strict textualism cannot sensibly restrict the relevant text to the statutory provision directly at issue. Once that fateful line is crossed, however, there is no logical stopping point until the limit of the text of all law is reached." *Id.* He further argues that if the relevant text is the text of all law, then strict textualism makes the outrageous suggestion that the legislature must have had the text of all law in mind when it enacted the particular provision. *See id.* at 23.

92. *See id.* at 37. "[I]n the domain of federal law Congress is the master and the Court is merely a servant." *Id.* Accordingly, "like any servant, a court is bound to give the instructions it receives from its master—statutes—a reasonable interpretation .... [which] always depends on all the contextual circumstances, not just on a literal reading of the text." *Id.*

93. *See infra* Part II.B.

94. *See infra* notes 95-98 and accompanying text.

95. *See* West Virginia Univ. Hosp., Inc. v. Casey, 499 U.S. 83, 98-99 (1991). In addressing the argument that the congressional purpose of enacting a statute must prevail over the ordinary meaning of the statutory terms, the Court held that when a statute "contains a phrase that is unambiguous - that has a clearly accepted meaning in both legislative and judicial practice - we do not permit it to be expanded or contracted . . ."

ute may clarify ambiguous provisions, "courts have no authority to *enforce* alleged principles gleaning *solely* from legislative history that has no statutory reference point."[96] Thus, the Court has held that statutory construction must always begin with the language of the statute.[97] When the language is clear, judicial inquiry into the statute's meaning, in all but the most extraordinary circumstances, is finished.[98] According to this view, a court's limited role is simply to apply a statute because Congress alone has the authority to make law.[99]

2. *Intentionalism*

A second tool of statutory interpretation is intentionalism. This method treats a statute as a static text, and "asks how the legislature originally intended the interpretive question to be answered, or would have intended the question to be answered had it thought about the issue when it passed the statute."[100] To ascertain intent, the court may look beyond the text to the statute's legislative history.[101] Proponents of the misappropriation theory often apply intentionalism, arguing that the policies underlying the theory are consistent with the intent of the legislators who enacted section 10(b).[102]

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96. International Bhd. of Elec. Workers, Local Union No. 474 v. NLRB, 814 F.2d 697, 699-700 (D.C. Cir. 1987).

97. *See* Cowart v. Nicklos Drilling Co., 505 U.S. 469, 475 (1922) (using textualism to hold that forfeiture provisions of a statute apply to a worker whose employer is neither paying compensation nor is subject to an order to pay under the statute at the time the worker settles with a third party).

98. *See id.*

99. *See, e.g., West Virginia Univ. Hosp.*, 499 U.S. at 101 ("[I]t is our role to make sense rather than nonsense out of the *corpus juris*.").

100. William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479-80 (1987).

101. *See* ESKRIDGE, *supra* note 84, at 14. Despite this inquiry into intent, the actual legislative intent is rarely brought to light from the historical record. *See id.* at 16.

102. *See, e.g.*, SEC v. Clark, 915 F.2d 439, 451 (9th Cir. 1990) (finding that while "it would be disingenuous to suggest that in 1942 the SEC sanctioned or even foresaw the use of the misappropriation theory. . . . its apparent understanding that Congress empowered it to draft a rule to address unforeseen species of fraud squares with our reading of § 10(b)'s contemporaneous legislative history."); United States v. Carpenter, 791 F.2d 1024, 1030 (2d Cir. 1986) (justifying the broad-reaching legislative intent of the 1934 Act in adopting the misappropriation theory); SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (noting that the antifraud provision of the 1934 Act was intended to be broad in scope, and was not "aimed solely at the eradication of fraudulent trading by corporate insiders.").

3. *Purposivism*

Another alternative is purposivism, which allows a court to consider the congressional purpose or policy behind the statute's enactment.[103] Using this approach, the purpose or objective of the statute must first be identified, then the statutory ambiguities can be resolved by determining which interpretation is most consistent with that purpose or goal.[104] Purposivism looks to Congress' intent in regulating an area, rather than its intent in enacting a particular statute.[105] As opposed to intentionalism, purposivism allows a statute to evolve to address new issues, while maintaining a connection with the original legislative expectations.[106] Notwithstanding this broader inquiry, it remains difficult under either approach to identify the purpose of a statute because legislatures do not always set forth the reasons for a law's enactment.[107] Moreover, because statutes are products of compromise, legislative histories often support divergent intentions.[108] Finally, this method calls for courts rather than Congress to make policy judgments,[109] and may ignore the plain meaning of a statute.[110]

4. *The Dynamic Theory*

The dynamic theory is a tool of statutory interpretation that has received considerable scholarly debate in recent years.[111] The dynamic theory suggests that courts should consider current policies and societal values in rendering decisions.[112] Proponents of this

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103. *See* Meetre, *supra* note 82, at 60; *see generally* ESKRIDGE, *supra* note 84, at 25-34.

104. *See* ESKRIDGE, *supra* note 84, at 25-26.

105. *See* Roger Colinvaux, *What Is Law? A Search for Legal Meaning and Good Judging Under a Textualist Lens*, 72 IND. L.J. 1133 (1997). In distinguishing the canons of construction, this commentator noted:

> A purposivist judge finds law by measuring a statute's language against the statute's purpose. For the task of discerning purpose, legislative history is a common choice. An intentionalist finds law by reconstructing congressional intent, also frequently relying on legislative history. Intentionalism differs from purposivism because a statute can be interpreted to have a broader purpose beyond the one intended.

Id. at 1133.

106. *See* ESKRIDGE, *supra* note 84 at 26.

107. *See id.* at 27.

108. *See id.*

109. *See* Meetre, *supra* note 82, at 61 (noting that both purposivism and intentionalism enable activist judges to "'rewrite' statutes to address matters").

110. *See id.*

111. *See generally* Carlos E. Gonzalez, *Reinterpreting Statutory Interpretation*, 74 N.C. L. REV. 585, 614-33 (1996). *See also* Gebbia-Pinetti, *supra* note 87, at 234 n.1.

112. "Under dynamic theory, 'the court's role is to reach the best result, formally

tool argue that "[i]nterpretation is not an archeological discovery, but a dialectic creation."[113] Statutes should not be treated as static texts because gaps and ambiguities always exist.[114] Instead, statutes should be interpreted dynamically, allowing them to evolve with current policies and perspectives.[115]

B. Interpreting Section 10(b)

In interpreting the language of section 10(b), the Supreme Court has generally employed textualism, reading the plain language of the statute to determine the meaning of the text.[116] *Ernst & Ernst v. Hochfelder*[117] is an exemplary case in which the Court decided whether section 10(b) reaches negligent conduct, or whether a defendant must act with an intent to deceive, manipulate, or defraud.[118] Relying on the language of section 10(b), specifically the words "manipulative or deceptive" used in conjunction with "device or contrivance," the Court held that the scope of section 10(b) liability does not extend to negligent conduct.[119] Accordingly, the Court refused to consider any policy arguments in reaching its decision.[120]

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unconstrained (though perhaps influenced or persuaded) by the statute's text and legislative history." Meetre, *supra* note 82, at 61 (quoting William N. Eskridge, Jr., *Politics Without Romance: Implications of Public Choice Theory for Statutory Interpretation*, 74 VA. L. REV. 275 (1988)).

113. Eskridge, *supra* note 100, at 1482 (citation omitted).

114. *See id.* at 1480.

115. *See id.* at 1483.

116. *See infra* notes 117-25 and accompanying text.

117. 425 U.S. 185 (1976).

118. *Id.* at 187-88 (1976). *Ernst & Ernst* involves an accounting firm charged with negligence for allegedly failing to conduct proper audits of a company keeping fraudulent escrow account. *See id.* at 190.

119. *See id.* at 197-98.

120. *See id.* at 198-99. Declining to entertain the policy concerns expressed by the SEC, the Court noted that "apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning." *Id.* On the contrary, the Court steadfastly refused to partake in judicial legislation. The Supreme Court has echoed this sentiment several times in the past. *See, e.g.*, Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 367 (1991) (Stevens, J. dissenting) ("Congress, rather than the Federal Judiciary, has the responsibility for making the policy determinations. . . "); Ernst & Ernst, 425 U.S. at 214 ("When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct."); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 748 (1975) ("[T]he Judiciary may not circumscribe a right which Congress has conferred because of any disagreement it might have with Congress about the wisdom of creating so expansive a liability.").

In *Santa Fe Industries, Inc. v. Green*,[121] the Supreme Court again employed textualism and declined to extend liability based on policy considerations because "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."[122] Therefore, the Court held that a breach of a fiduciary duty without any deception, misrepresentation, or nondisclosure does not give rise to liability under section 10(b) or Rule 10b-5.

Similarly, the Court strictly interpreted section 10(b) in its recent *Central Bank of Denver v. First Interstate Bank of Denver*[123] decision. Addressing the seemingly resolved issue of whether a private right of action for aiding and abetting could be brought pursuant to section 10(b),[124] the Court held that because the statute's plain language did not create or impose such liability, it did not exist.[125]

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121. 430 U.S. 462 (1977). In *Santa Fe*, the Court considered a section 10(b) suit brought by minority shareholders against majority shareholders and a firm which had appraised the value of a stock for purposes of a Delaware short-form merger. *See id.* at 466-67. Because the minority shareholders could either accept the price offered or reject it and seek appraisal in the Delaware Court of Chancery, the transaction was neither deceptive nor manipulative and therefore did not violate section 10(b) or Rule 10b-5. *See id.* at 474.

122. *Id.* at 473.

123. 511 U.S. 164, 173 (1994) ("With respect . . . [to] the scope of conduct prohibited by § 10(b), the text of the statute controls our decision.").

124. The dissenting opinion noted that "[i]n *hundreds* of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5." *Id.* at 192 (Stevens, J., dissenting) (emphasis in original). However, the Court was not persuaded by the fact that all eleven courts of appeals had recognized aiding and abetting liability. *See id.* Acknowledging that aiding and abetting should be actionable in certain circumstances, the Court would not budge. "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." *Id.* at 177. The Court declared that "[p]olicy considerations cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." *Id.* at 188 (quoting Demarest v. Manspeaker, 498 U.S. 184, 191 (1991)).

Similarly, when the Fourth Circuit was confronted with the policy justifications for adopting the misappropriation theory, it responded:

> [I]n securities law, as in all areas of the law, our perceptions of what is wise or fair are ultimately of no relevance. In the end, we, as judges, no less than anyone else, are bound by the actual prohibitions enacted by Congress. It is adherence to this fundamental limitation on our own authority that leads us to conclude that, as ignoble as Bryan's conduct was, it simply was not conduct that is prohibited by section 10(b) of the Securities Exchange Act of 1934.

United States v. Bryan, 58 F.3d 933, 959 (1995).

125. *See Central Bank*, 511 U.S. at 177. Because the language of section 10(b) does

In all of these cases, the Supreme Court determined the scope of section 10(b) by analyzing the language of the statute and its relatively sparse legislative history.[126] Until *United States v. O'Hagan*, the Court focused solely on the plain meaning of the statute and consistently held that fraud is the critical component of section 10(b) liability.[127] In *O'Hagan*, the Court's steadfast refusal to expand the scope of the statute beyond what the language permits ended.

C. *United States v. O'Hagan*

The Supreme Court directly discussed the validity of the misappropriation theory in *O'Hagan*.[128] The Court decided that James O'Hagan, a lawyer, violated section 10(b) and Rule 10b-5 when he traded stocks using confidential client information he learned while working as a partner at a law firm.[129] Following an investigation by

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not mention aiding and abetting, the Court held that "[i]t is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text." *Id.* Rather, "ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section." *Id.* at 175 (quoting Pinter v. Dahl, 486 U.S. 622, 653 (1988)). Based upon this straightforward analysis, the Court found that there can be no aiding and abetting liability under section 10(b). *See id.* at 177. The Court went on to note that if the statute itself does not resolve the case, as it did here, it must attempt "to infer 'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act.'" *Id.* at 178 (quoting Musick, Peeler & Garrett v. Employers Insurance, 508 U.S. 286, 294 (1993)).

126. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) ("Neither the intended scope of § 10(b) nor the reasons for the changes in its operative language are revealed explicitly in the 1934 Act . . .").

127. *See* Chiarella v. United States, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud."); Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

128. 117 S. Ct. 2199 (1997).

129. *See id.* at 2205. James O'Hagan was a partner at the law firm of Dorsey & Whitney. *See id.* at 2205. In July 1988, Grand Metropolitan PLC ("Grand Met") retained Dorsey & Whitney as local counsel regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis, Minnesota, a transaction which did not involve O'Hagan. *See id.* The firm, which was also located in Minneapolis, severed the relationship with Grand Met in September, in light of its policy against representing a company involved in a hostile takeover of a local corporation. *See id.* In August 1988, while Dorsey & Whitney still represented Grand Met, O'Hagan began purchasing call options for Pillsbury stock, and by the end of September, he had gathered 2,500 Pillsbury call option contracts, and owned approximately 5000 shares of Pillsbury common stock. *See id.* On October 4, 1988, Grand Met announced its tender offer for Pillsbury stock, and the price per share immediately increased from $39 to $60. *See id.* O'Hagan subsequently purchased the stock

the SEC and other federal law enforcement agencies, O'Hagan was charged and convicted of fifty-seven counts of mail fraud, securities fraud, and money laundering, and sentenced to forty-one months' imprisonment.[130] On appeal, the Eighth Circuit reversed O'Hagan's convictions, holding that the misappropriation theory is not a valid basis upon which to impose criminal liability under section 10(b).[131]

1. *The Eighth Circuit's Analysis*

The Eighth Circuit, in *O'Hagan*, found that the misappropriation theory was at odds with the explicit language of section 10(b).[132] Relying on the Supreme Court's prior readings of the statute, the Eighth Circuit defined deception as the making of a material misrepresentation or nondisclosure of material information in violation of a duty to disclose.[133] The court then decided that deception was critical to section 10(b) liability and, therefore, the misappropriation theory was problematic because it did not require any misrepresentation or nondisclosure in breach of a duty.[134] Moreover, the court reasoned that although the misappropriation theory does not require deception as mandated by section 10(b), even if it did, "it renders nugatory the requirement that the 'deception' be 'in connection with the purchase or sale of any security.'"[135]

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at the lower price by exercising his call options, then sold all of his shares for a profit of over $4,000,000. *See id.*

130. *See id.*

131. *See id.* at 2206.

132. *See* United States v. O'Hagan, 92 F.3d 612, 618 (8th Cir. 1996) ("By its very definition . . . [the misappropriation theory] does not require either a material misrepresentation or nondisclosure."). The court borrowed heavily from the Fourth Circuit's decision, in *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), which concluded 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." *Id.* at 944.

133. *See O'Hagan*, 92 F.3d at 617.

134. *See id.* (relying on *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 470-76 (1977), the court noted that the Supreme Court had already rejected a lower court's reading of section 10(b) which required no misrepresentation or nondisclosure); *see also* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177 (1994), *cited in O'Hagan*, 92 F.3d at 618 (reiterating this principle); *see also supra* notes 123-25.

135. O'Hagan, 92 F.3d at 617. In *Bryan*, the Fourth Circuit found that 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." *Bryan*, 58 F.3d at 950 (emphasis in original). Further developing this analysis, the *O'Hagan* court explained

2. The Supreme Court's Analysis

The Supreme Court rejected the Eighth Circuit's argument that the misappropriation theory did not satisfy section 10(b)'s deception requirement. The Court explained that the duty breached under the misappropriation theory is a duty which runs to the source of information.[136] In addition, the *O'Hagan* Court limited liability under the misappropriation theory by holding that full disclosure will foreclose the liability of someone who breaches a relationship of trust.[137] If the fiduciary discloses his plans to trade on

that the misappropriation theory improperly "permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . . ' statutory language." *O'Hagan*, 92 F.3d at 618. Thus, "the Misappropriation Theory separates the inseparable . . . [and] disregards the specific statutory requirement of deception, in favor of a requirement of a mere fiduciary breach[.]" David Cowan Bayne, S.J., *Insider Trading: The Demise of the Misappropriation Theory – And Thereafter*, 41 ST. LOUIS U. L.J. 625, 637 (1997); *see also* Brodsky & Kramer, *supra* note 38, at 138. Brodsky and Kramer argue:

> By severing the link between the fraud (breach of duty) and the securities trade at issue, the misappropriation theory brings within its scope parties who have no connection with issuers or their shareholders and is premised upon breaches of duty that have nothing to do with securities markets. It creates irrational distinctions, where some familial, employment or professional relationships creates a duty to disclose or refrain from trading, whereas others (ones where the expectations of trust are deemed diminished) do not.

Id. However, the Supreme Court's decisions in *Chiarella*, *Dirks* and *Central Bank* show that these requirements cannot be separated. The breach must be to parties in a relationship of trust and confidence in order to give rise to section 10(b) liability. *See O'Hagan*, 92 F.3d at 618. In *Chiarella*, the Court held that a duty to disclose arises only "from a relationship of trust and confidence between parties to a transaction." Chiarella v. Unites States, 445 U.S. 222, 230 (1980). Similarly, in *Dirks*, the Court stated 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.'" Dirks v. SEC, 463 U.S. 646, 657-58 (1983) (quoting *Chiarella*, 445 U.S. at 231-32 n.14).

136. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2207 (1997). "A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain,' . . . 'dupes' or defrauds the principal." *Id.* at 2208 (quoting Brief for the United States 17). The Court did not adopt the version of the theory originally proposed by Chief Justice Burger in *Chiarella*, which would impose a disclosure obligation to all those with whom the misappropriator trades, but rather limited the disclosure obligation to the source of information. *See id.* at 2208 n.6. Under Burger's version of the theory, "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting).

137. *See O'Hagan*, 117 S. Ct. at 2209. The Court noted that:

> full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the

the nonpublic information to the source of the information, then there exists neither any purported fidelity to the source nor a "deceptive device" to give rise to section 10(b) liability.[138]

The Supreme Court also found satisfied the requirement that the misappropriator's deceptive use of information be "in connection with the purchase or sale of a security," because the fraud occurs only when securities are bought or sold in the market.[139] The Court reasoned that if the fiduciary used the nonpublic information in ways not involving trading on the securities market, no section 10(b) violation would exist.[140]

III. *O'Hagan* Dissected

The Supreme Court disagreed with the Eighth Circuit's interpretation that *Chiarella*,[141] *Dirks*,[142] and *Central Bank*[143] held that section 10(b) liability cannot be predicated on a duty owed to the source of nonpublic information.[144] Attempting to distinguish

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> source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation . . .

Id.

138. *See id.* at 2209. However, "the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty." *Id.*

139. *Id.* ("[T]he fiduciary's fraud is consummated not when [he learns the] information, but when, without disclosure to his principal, he uses [it] to purchase or sell securities.").

140. *See id.* "The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions." *Id.* Asserting that this is another limitation on the forms of fraud section 10(b) reaches, the Court gave an example of a situation where the misappropriation theory would not apply: a person who defrauded a bank into giving him a loan or embezzled cash from another, and then used the proceeds from the fraud to purchase securities would not give rise to section 10(b) liability since "'the proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained.'" *Id.* (quoting Brief for United States at 24 n.13, *O'Hagan*). The dissent found this analysis to be very troubling. "[I]t becomes plain that the majority's explanation of how the misappropriation theory supposedly satisfies the 'in connection with' requirement is incomplete. The touchstone required for an embezzlement to be 'use[d] or employ[ed], in connection with' a securities transaction is not merely that it 'coincide' with, or be consummated by, the transaction, but that it is *necessarily* and *only* consummated by the transaction." *Id.* at 2222 (Thomas, J., dissenting) (emphasis in original). The Court concluded that the misappropriation theory squares with the language of section 10(b) requiring deception "in connection with the purchase or sale of any security." *See id.* at 2210.

141. 445 U.S. 222 (1980); *see supra* notes 32-37 and accompanying text.

142. 463 U.S. 646 (1983); *see supra* notes 39-43 and accompanying text.

143. 511 U.S. 164 (1994); *see supra* notes 123-25 and accompanying text.

144. *See* United States v. O'Hagan, 92 F.3d 612, 619 (8th Cir. 1996) ("Against this venerable body of law, the misappropriation theory, which allows the imposition of

these cases, the Court stated that although it declined to find liability on "so broad a theory" in *Chiarella*, its decision did not limit liability to the relationship between a corporation's insiders and shareholders.[145] Similarly, the *Dirks* decision did not foreclose liability under the misappropriation theory because the information at issue was not improperly acquired or misused.[146] Finally, under its *Central Bank* decision, the Supreme Court held that there is no private right of action for aiding and abetting liability under section 10(b), but cautioned that secondary actors may still be liable under section 10(b) and Rule 10b-5 for certain conduct.[147] Accordingly, the Court found no inconsistencies between the misappropriation theory and its previous decisions.[148]

Rather than continue to limit the reach of section 10(b) and Rule 10b-5, the *O'Hagan* Court extended the prohibition of trading on material, nonpublic information. However, if the *O'Hagan* decision is consistent with previous cases, as the Court suggests, why is this result so different? The answer lies in the canon of construction employed by the *O'Hagan* Court. The majority was persuaded that the misappropriation theory is "well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence."[149] The *O'Hagan* decision, therefore, was not reached using textualism, but rather, purposivism:

> In sum, considering the *inhibiting impact on market participation* of trading on misappropriated information, and the *congressional purposes underlying § 10(b)*, it makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works

§ 10(b) liability even though no market participant was deceived or defrauded, cannot be defended.").

145. *See O'Hagan*, 117 S. Ct. at 2211-12 (noting that the Court declined to find the defendant liable because the misappropriation theory had not been submitted to the jury, but in fact, four Justices found merit in it).

146. *See id.* at 2213; *see supra* note 43 and accompanying text.

147. *See O'Hagan*, 117 S. Ct. at 2213. In *Central Bank*, the Court stated: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) *on which a purchaser or seller of securities relies* may be liable as a primary violator under 10b-5, assuming . . . the requirements for primary liability under Rule 10b-5 are met." *Central Bank*, 511 U.S. at 191 (emphasis added). The *O'Hagan* Court explained that the Eighth Circuit improperly understood this passage to mean that only deceptive statements or omissions on which purchasers, sellers, and perhaps other market participants, rely are covered by section 10(b). *O'Hagan*, 117 S. Ct. at 2213.

148. *See O'Hagan*, 117 S. Ct. at 2213-14.

149. *Id.* at 2210.

for a law firm representing the bidder.[150]

A. The Methodology of Purposivism in *O'Hagan*

By the time it considered *O'Hagan*, the Supreme Court had addressed the scope of liability under section 10(b) and Rule 10b-5 in a number of cases using a textualist approach.[151] The *O'Hagan* Court, however, rendered its decision based on policy reasons, using a purposivist approach. Although it arguably may be proper to impose liability on those who misappropriate confidential information, the misappropriation theory is not the proper means because it requires an overly broad interpretation of the language of section 10(b). Moreover, when a statute is written in vague and uncertain terms, it should be construed as narrowly as possible, to avoid inconsistent results.[152]

1. *Proponents of the Misappropriation Theory Advocate a Purposivist Approach*

After the Supreme Court's decision in *Central Bank*,[153] the misappropriation theory received a great deal of scholarly debate, with many judges and commentators advocating both intentionalism and purposivism as approaches to interpreting section 10(b).[154] The misappropriation theory has gained judicial favor because our country values so highly the securities market that courts will go to great lengths to protect people's confidence in it.[155]

Proponents argue that the misappropriation theory is consistent with the underlying purpose behind the securities laws.[156] When

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150. *Id.* at 2210-11 (emphasis added).

151. *See supra* Part II.B.

152. *See* Grundfest, *supra* note 8, at 42-45.

153. 511 U.S. 164 (1994).

154. *See* United States v. Carpenter, 791 F.2d 1024, 1029 (2d Cir. 1986) ("[W]e think that the application of the misappropriation theory herein promotes the purposes and policies underlying section 10(b) and Rule 10b-5"); Aldave *supra* note 8, at 122 ("The misappropriation theory . . . comports well with our intuition about what is wrong with trading on nonpublic information.").

155. *See* Spencer Derek Klein, Note, *Insider Trading, SEC Decision-Making, and the Calculus of Investor Confidence*, 16 HOFSTRA L. REV. 665 (1988) (discussing the nexus between insider trading and investor confidence).

156. The securities laws were created in order to regulate the troubled securities markets and to restore peoples confidences in them. *See* Thel, *supra* note 16, at 425; Aldave, *supra* note 8, at 122-23 (stating that in order to maintain the integrity of the securities market, it must remain fair, as "no one likes to play a game with an opponent who has a loaded dice."). Aldave, whose analysis the Supreme Court relied on in *O'Hagan*, explained that "[w]e think that those who have special access to information, because of employment or other relationships, should be barred from using that

Congress enacted section 10(b) of the Securities and Exchange Act, it did so for the purpose of protecting purchasers and sellers of securities.[157] Thus, proponents urge that the misappropriation theory is in accord with the statute's goal, because "Congress chose to enact a comprehensive yet open-ended statutory scheme, capable of ongoing adaptation and refinement."[158] The misappropriation theory may also be accepted under purposivism because it advances the policy of basic fairness.[159]

2. *Purposivism Is Not the Appropriate Tool for Interpreting Section 10(b)*

The Supreme Court's purposivist approach in *O'Hagan* is not an appropriate method of interpreting section 10(b). Instead, courts should rely on textualism alone because liability under section 10(b) and Rule 10b-5 risks being expanded without limit, leaving investors as well as the courts without a clear understanding of prohibited conduct.[160]

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information to gain an advantage over the rest of us." *Id.* Aldave concluded that "[t]he Court's adoption of the misappropriation theory would produce results consistent with our notions of fairness . . ." *Id.* at 124.

Interestingly, Rule 10b-5 itself was hastily created to address a situation where the president of a corporation who misinformed the shareholders of the condition of the corporation subsequently purchased the shares of the company from the shareholders at depressed prices. The general unfairness of this event led to the drafting and adoption of the rule in one day, with the Commissioner's explanation: "Well, we are against fraud, aren't we?" *See* Brodsky & Kramer, *supra* note 38, at 110.

157. *See* United States v. Bryan, 58 F.3d 933, 946-47 (4th Cir. 1995).

158. SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984). The repeated use of the word "any" evidences the intention of Congress to draft the rule broadly. *See* Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972). In fact, when it passed the Insider Trading Sanction Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, and the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. 100-704, 102 Stat. 4677, Congress found the misappropriation theory to be consistent with section 10(b) and Rule 10b-5. *See* SEC v. Clark, 915 F.2d 439, 452 (9th Cir. 1990). Section 10(b) was intended to be broad in scope, encompassing all "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. REP. NO. 792, at 6 (1934).

159. In *United States v. Carpenter*, the Second Circuit explained that "the application of the misappropriation theory herein promotes the purposes and policies underlying Section 10(b) and Rule 10b-5." United States v. Carpenter, 791 F.2d 1024, 1029 (2d Cir. 1986).

160. *See* Grundfest, *supra* note 8, at 41-43. Grundfest compares poorly drafted statutes, particularly section 10(b), to an inkblot in a Rorschach test, which is a series of inkblots used in psychiatric analysis, where the patient describes the images evoked by the inkblots and the analyst interprets the patients descriptions. The inkblots themselves have no intrinsic meaning. *See id.* "When a statute presents itself as an inkblot, it should be construed as narrowly as practicable lest it become a breeding ground for competing judicial imaginations." *Id.* at 42. Grundfest found the federal

The Court may find it necessary to interpret the securities laws flexibly because regulating the securities industry has become increasingly difficult as technological advances and communication systems have become more sophisticated.[161] Unfortunately, Congress has not been able to keep up with new problems as they have evolved. Thus, by using a purposivist approach to interpret section 10(b), the Court can remedy any problems by advancing the underlying purpose of the securities laws, which is to promote ethical standards in the securities market and to protect investors from fraud.[162]

Purposivism creates a problem, however. First, it permits courts to legislate on a case-by-case basis without the benefit of congressional hearings, or the accountability of elected legislative officials. This, of course, offends the traditional role of the courts, which is limited to interpreting the laws that the legislature enacts. Although courts certainly have considerable discretion in interpreting statutes, judicial activism without deference to Congress is not appropriate.

Second, there will be no limit to the scope of liability under section 10(b) if courts can look to merely the purpose of enacting the

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securities law, and in particular section 10(b), to be extremely ambiguous, thereby enabling judges who strongly oppose fraud in the securities markets to extend the language of section 10(b) without limit. *See id.* at 44. He found the great ambiguity to be evidenced by the number of times the Court has split 5-4 in cases interpreting federal securities law. *See id.* at 45, 48-55. Grundfest criticizes the intentionalist approach to interpreting section 10(b), given the instability of congressional intent over time. *See id.* at 57.

> Intentionalists thus confront the uncomfortable problem that, if they look to the intent of the Congress that in 1934 enacted section 10(b) they find no guidance, but if they look to the intent of subsequent Congresses they can infer sharply conflicting guidance depending on where their intentionalist time machines stop along the way.

Id. at 58.

161. *See* Bevis Longstreth, *The SEC After Fifty Years: An Assessment of its Past and Future*, 83 COLUM. L. REV. 1593, 1610 (1983) ("The growing internationalization of the securities markets will pose another challenge for the Commission in the coming years. As advances in communications technology make the situs of trading in securities less important, the Commission will face increasing difficulty in ensuring that its investor protections reach all transaction in world class securities effected by or for the benefit of U.S. citizens."); Lewis D. Solomon & Louise Corso, *The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications for Regulation*, 24 J. MARSHALL L. REV. 299, 328 (1991) (book review) ("Advances in technology will continue to increase the globalization of the securities markets. . . .[and] [t]he globalization of securities creates new challenges for securities regulators around the world.").

162. *See supra* text accompanying notes 17-18.

law. Given the broad purposes and goals of the 1934 Act,[163] it is obvious that a purposivist approach may be overreaching.[164] Further, interpreting the statute in such a way will have the effect of making liability for trading securities unpredictable.

While the issue of statutory interpretation is certainly unresolved, it is anomalous for the Court suddenly to shift gears after using textualism to interpret section 10(b) for over twenty years.[165] The Court's sudden shift in its method of interpreting section 10(b) may be explained by the fact that fairness is a particularly important principle in securities trading, and as many tools as possible are needed to protect the markets. The purposivist argument[166] is understandable when applied to the facts of *O'Hagan* because, if a strict textual reading of section 10(b) would free someone as culpable as O'Hagan, then textualism must be improper. This argument is unconvincing, however, because it enables courts, instead of Congress, to make laws, which is a clear violation of the separation of powers.[167]

The Supreme Court should refrain from policy-making, and interpret section 10(b) according to its plain language.[168] By finding that liability under this statute may be predicated on the misappropriation theory, the Court contradicted its own precedent, and substituted its own policy judgments for the letter of the law.[169]

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163. *See id.*

164. For example, under a purposivist approach, Dirks would probably have been found guilty of violating section 10(b), despite the absence of a breach of duty, because a court would likely find that his conduct conflicted with the goal of promoting ethical standards in the market despite his effort to expose a fraud. *See* Dirks v. SEC, 463 U.S. 646 (1983); *supra* notes 39-43 and accompanying text.

165. *See supra* Part II.B. In *Ernst & Ernst v. Hochfelder*, the Court held that "[i]n addressing [the question of whether negligent conduct is a basis for 10(b) liability], we turn first to the language of § 10(b), for '[t]he starting point in every case involving construction of a statute is the language itself.'" Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975)).

166. *See supra* notes 103-110 and accompanying text.

167. *See, e.g.*, New York Times Co. v. United States, 403 U.S. 713, 742 (1971) ("It would . . . be utterly inconsistent with the concept of separation of powers for this Court to use its power . . . to prevent behavior that Congress has specifically declined to prohibit.") (Marshall, J., concurring).

168. *See* Joseph J. Humke, Comment, *The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 835 (1997) ("Simply stated, absent a well-articulated legislative record specifically addressing the provision and question at issue, which is simply not the case with respect to insider trading under section 10(b), textualism directs judicial interpretation of the securities laws.").

169. As proponents of the misappropriation theory suggest, Congress enacted section 10(b) in order to proscribe a broad range of fraudulent conduct in connection

B. The Misappropriation Theory is Inconsistent with Section 10(b)

The misappropriation theory, as adopted by the Supreme Court in *O'Hagan*, permits liability absent the requisite "fraud" and "in connection with" requirements of section 10(b). Despite the Court's policy arguments, the misappropriation theory, as a matter of law, does not satisfy the statutory requirements.

1. *The Misappropriation Theory Permits Liability Absent Fraud*

First, the misappropriation theory does not satisfy the fraud requirement of section 10(b) and Rule 10b-5. Many commentators and judges suggest that the misappropriation theory does not fit easily into a traditional fraud analysis because the breach is not between an insider and the shareholders of a corporation.[170] While the Supreme Court in *O'Hagan* found that liability under this theory is limited when a fiduciary discloses the information,[171] in many cases, "early disclosure of the misappropriated information would have only further harmed the person or entity to whom the duty was owed."[172]

Although many courts have adopted the misappropriation theory,[173] the Eighth Circuit is not alone in its unfavorable interpreta-

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with the purchase or sale of securities. It bears remembering that the language of section 10(b) and Rule 10b-5 do not even cover traditional insider trading. *See* Fisch, *supra* note 12, at 187-99 (arguing that the doctrine under which insider trading is regulated is seriously flawed). Further, "[n]either the words of section 10(b) nor the statute's legislative history manifest any Congressional intent to have the federal judiciary interpret section 10(b) as enabling legislation for the formulation of judicial public policy." Kenny & Thebaut, *supra* note 47, at 210. The Supreme Court has declared that the creation of a new species of fraud under section 10(b) would "depart[ ] radically from the established doctrine that duty arises from a specific relationship between two parties . . . [and] should not be undertaken absent some explicit evidence of congressional intent." Chiarella v. United States, 445 U.S. 222, 233 (1980). Ascertainment of legislative intent, according to the Court, must "rest primarily on the language" of section 10(b). Santa Fe Indus. v. Green, 430 U.S. 462, 472 (1997).

170. The "duty breached by persons found liable under the misappropriation theory is different from the duty arising out of an insider's relationship to the corporation's shareholders." Brodsky & Kramer, *supra* note 38, at 132; *see* United States v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995). *Cf.* SEC v. Cherif, 933 F.2d 403, 410 n.5 (7th Cir. 1991) ("There is little question that the vague term 'fraud' as used in Section 10(b) and Rule 10b-5 can encompass the misappropriation theory."); SEC v. Clark, 915 F.2d 439, 448-49 (9th Cir. 1990) (concluding that "the misappropriation theory fits comfortably" within "the notoriously vague" terms of section 10(b) and Rule 10b-5).

171. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2209 (1997).

172. Brodsky & Kramer, *supra* note 38, at 132. *See, e.g.*, United States v. Willis, 737 F. Supp. 269, 274 (S.D.N.Y. 1990) (stating that disclosure violates the client-doctor privilege).

173. *See supra* note 79 and accompanying text.

tion of it.[174] The Supreme Court itself has ordered that the concept of fraud in the securities context not be expanded beyond what the words of the 1934 Act permit.[175] It has also established that section 10(b) and Rule 10b-5 do not remedy every instance of undesirable conduct involving securities,[176] and that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."[177]

2. *Misappropriation Theory Permits Liability Absent the "In Connection With" Requirement*

Generally, the courts that adopted the misappropriation theory were also very lenient with respect to the requirement that the fraud be committed "in connection with the purchase or sale of any security."[178] The Supreme Court, in *O'Hagan*, explained that the fraud is complete only when the information has been used in a securities transaction.[179] Because the fraud is not consummated when the fiduciary gains the confidential information, but rather, occurs when he uses it to purchase or sell securities without disclosure, the nexus is necessarily present.[180]

This principle, however, is a radical departure from the Court's recent strict interpretation of the language of section 10(b) and Rule 10b-5 where it held that the "in connection with" requirement was satisfied only when the fraud affects the financial marketplace

174. *See supra* note 78 and accompanying text. The Fourth Circuit was the first jurisdiction to break ranks and find that the misappropriation theory is irreconcilable with Supreme Court precedent. *See Bryan*, 58 F.3d at 944. The court found it troublesome that the "fraud" requirement is met when a person misappropriates material, nonpublic information in breach of some special duty, even if the source of the information is neither a purchaser or seller of securities, nor in any way connected to the purchase or sale of securities. *See id.*

175. *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 174 (1994).

176. *See* Moss v. Morgan Stanley Inc., 719 F.2d 5, 16 (2d Cir. 1983) (discussing Chiarella v. United States, 445 U.S. 222, 232 (1980); Santa Fe Indus. v. Green, 430 U.S. 462, 474-77 (1977)).

177. *Santa Fe Indus.*, 430 U.S. at 473; see *supra* notes 121-22 and accompanying text for a discussion of *Santa Fe.*

178. *See, e.g., Clark*, 915 F.2d at 449 ("[T]he question here is whether there is some nexus between [the defendant's] misappropriation of . . . confidential information and any securities transaction."). For example, in *United States v. Newman*, even though the fraud was not against a purchaser or seller of securities, the court held that the "in connection with" requirement was met since Newman's "sole purpose" in misappropriating the information was to purchase stock in the target companies. United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981); *see supra* notes 74-76 and accompanying text.

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

180. *See id.*

and the victim is a defrauded purchaser or seller.[181] As the dissent in *O'Hagan* pointed out, the misappropriation theory should not cover cases involving fraud on the source of information where the source has no connection with the other participant in a securities transaction.[182]

3. *Congress Should Intervene with a Statute*

Few would argue that James O'Hagan's behavior was not reprehensible and should go unpunished.[183] The misappropriation theory, however, may not be so easy to accept when the conduct amounts to no more than a breach of an employment contract,[184] breach of the psychiatrist-patient confidence,[185] failure to keep nonpublic business information within the family,[186] or basic theft and burglary.[187] The appeal for redress is understandable when information is misappropriated and used to trade on the securities markets. Although there may be a need for federal standards to protect investors against the mishandling of material, nonpublic information, the Supreme Court has instructed that such standards "should not be supplied by judicial extension of § 10(b) and Rule 10b-5 to 'cover the corporate universe.'"[188]

Instead, Congress should intervene to finally resolve this issue by creating a statute which clearly and directly addresses liability for insider trading. Professor Jill Fisch offers a unique proposal that

181. *See* Fisch, *supra* note 12, at 195 (analyzing *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975)).

182. *See O'Hagan*, 117 S. Ct. at 2223 (Thomas, J., dissenting). Justice Thomas noted that O'Hagan could have done a number of things with the information he acquired: "He could have sold it to a newspaper for publication, he could have given or sold the information to Pillsbury itself, or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game." *Id.* (internal citations omitted). The fact that he chose to purchase securities based on the information "is thus no more significant here than it is in the case of embezzling money used to purchase securities." *Id.*; *see supra* note 140 and accompanying text.

183. In addition to purchasing securities based on information he had access to through his employment at the law firm, O'Hagan allegedly used the profits gained through this unlawful trading to conceal his previous embezzlement and conversion of unrelated client trust funds. *See O'Hagan*, 117 S. Ct. at 2205.

184. *See* SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990); United States v. Carpenter, 791 F.2d 1024, 1026 (2d Cir. 1986); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981).

185. *See* United States v. Willis, 737 F. Supp. 269, 274 (S.D.N.Y. 1990).

186. *See* United States v. Chestman, 947 F.2d 551, 568 (2d Cir. 1991); United States v. Reed, 601 F. Supp. 685, 705 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

187. *See* SEC v. Cherif, 933 F.2d 403, 411 (7th Cir. 1991).

188. Santa Fe Indus. v. Green, 430 U.S. 462, 480 (1977) (internal citation omitted).

would replace the concept of regulation based on the trader's fiduciary duties with a system of regulation based on insider status.[189] Specifically, Fisch's proposed statute defines two groups with insider status: "primary insiders" and "secondary insiders," and restricts these insiders from trading on information obtained by virtue of their status.[190]

By regulating the unlawful trading in the securities market through explicit legislative action, Congress could respect the doctrine of the separation of powers. In addition, a congressional statute, such as the one proposed by Professor Fisch, can better resolve the problems of unlawful trading because it equips the courts with a clear standard that can easily be applied whenever there in an allegation of unlawful trading.

The misappropriation theory, adopted by *O'Hagan*, shifts the focus of section 10(b) from protecting investors in the securities market to protecting the sources of confidential information. Even the scant evidence of legislative history makes clear that this was not the purpose of the statute. Therefore, the misappropriation theory not only goes beyond the text of the statute, but it also reaches beyond the underlying purpose of the statute.

Moreover, the misappropriation theory makes potential liability less predictable under section 10(b),[191] and the *O'Hagan* decision does nothing to alleviate the problem. When addressed with this problem in the past, the Supreme Court has emphasized that the

189. Fisch, *supra* note 12, at 238-39.

190. Primary insiders include those who have "(1) the ability to affect the content and timing of corporate disclosure; (2) regular access to information on significant corporate events; and (3) the ability to affect the decisionmaking process about such events." *Id.* at 240-41. "Secondary insiders are those who by virtue of an employment or other contractual relationship receive nonpublic information relating to the issuer or its securities for the purpose of advising or rendering services to the corporation or its management." *Id.* at 241. Under her proposed statute, primary insiders who, due to their status as an insider, possess material, nonpublic information relative to any security, are prohibited from taking advantage of that information by tipping or trading. *See id.* at 242. Secondary insiders are prohibited from taking advantage of material, nonpublic information relative to any security, obtained by their relationship with the corporation. *See id.* Further, "tippee trading would be regulated indirectly by requiring tippers to be responsible for the economic consequences of tippee trading." *Id.* at 247-48.

191. *See Bryan*, 58 F.3d at 951 ("It would be difficult to overstate the uncertainty that has been introduced into the already uncertain law governing fraudulent securities transactions through adoption of the misappropriation theory, with its linchpin the breach of a fiduciary duty."); *see also Chestman*, 947 F.2d at 567, ("Our Rule 10b-5 precedents under the misappropriation theory . . . provide little guidance with respect to the question of fiduciary breach, because they involved egregious fiduciary breaches arising solely in the context of employer/employee associations.").

securities market "'demands certainty and predictability,'"[192] and that it is "essential . . . to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's insider-trading rules."[193] While it is not difficult to argue that James O'Hagan breached a fiduciary duty, in several cases where courts have imposed liability under the misappropriation theory, the breach has not been so clear.[194] Unlike the misappropriation theory, a congressional statute would provide the certainty and predictability needed to regulate this area.

Finally, although Professor Fisch argues that insider trading should not be criminalized,[195] civil penalties alone will not provide sufficient deterrence for those with access to valuable market information. If insiders are required merely to disgorge profits when they are caught illegally taking advantage of material, nonpublic information, it may be worth their risk to continue such unlawful activity. Rogue investors attempting to trade on misappropriated information will have an incentive to keep trying until they eventually are successful. Accordingly, there should be criminal penalties for this type of unlawful insider trading, consisting of harsh fines and imprisonment.

Conclusion

The Supreme Court should interpret section 10(b) based on its plain language in order to respect the role of Congress as lawmaker, and its own role as interpreter of the law. In *O'Hagan*, the Court improperly extended liability under section 10(b) to reach a culpable defendant whose conduct was not covered by the language of the statute or the rule. The courts, however, simply are not competent to regulate in the complicated area of securities law.

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192. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188 (1994) (quoting Pinter v. Dahl, 486 U.S. 622, 652 (1988)).

193. Dirks v. SEC, 463 U.S. 646, 664 (1983).

194. For instance, the Second Circuit, in *Chestman*, struggled to define a line to establish the necessary fiduciary relationship. *See Chestman*, 947 F.2d at 567-71. *O'Hagan* merely condoned the theory, without directing the courts as to the limits of its application. The *Bryan* Court, which championed the fight against the misappropriation theory, stated that "although fifteen years have passed since the theory's inception, no court adopting the misappropriation theory has offered a principled basis for distinguishing which types of fiduciary or similar relationships of trust and confidence can give rise to Rule 10b-5 liability and which cannot." *Bryan*, 58 F.3d at 951.

195. *See* Fisch, *supra* note 12, at 237-38 (suggesting that because "insider trading cannot readily be equated with either stealing or lying . . . classifying such trading as criminal and penalizing it with stiff prison sentences should be reconsidered."). Instead, Fisch suggests insider trading be enforced by civil disgorgement. *See id.* at 251.

Instead, Congress alone is responsible for making laws that will punish people like James O'Hagan. Thus, Congress should draft a statute that will protect market participants, rather than the sources of market information, thereby serving the underlying purpose of section 10(b).