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Cover Page Footnote

The author would like to thank Jon Biondo for his enduring patience and support.

COMMENT

IN DEFENSE OF *UNITED STATES V. BRYAN*: WHY THE MISAPPROPRIATION THEORY IS INDEFENSIBLE

*Timothy J. Horman**

INTRODUCTION

In September 1993, a jury convicted Elton Bryan, former director of the West Virginia Lottery, on various counts of mail, wire, and securities fraud and the court sentenced him to fifty-one months in prison.[1] Bryan, while serving as director of the West Virginia Lottery, fraudulently manipulated the awarding of two contracts and, with access to confidential information regarding these contracts, purchased the securities of a company that had received one of the contracts.[2] In charging Bryan with securities fraud under section 10(b) of the Securities Exchange Act of 1934[3] ("section 10(b)") and Rule 10b-5[4] promulgated thereunder, the government relied upon the "misappropriation theory" of insider trading liability.[5] This theory imposes liability on one "who '(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless

* The author would like to thank Jon Biondo for his enduring patience and support.

1. United States v. Bryan, 58 F.3d 933, 936 (4th Cir. 1995).

2. *Id.* at 937-39.

3. Section 10 of the Securities Exchange Act of 1934 ("Exchange Act") provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . 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 (1994).

4. Pursuant to its authority under section 10(b), the Securities and Exchange Commission ("SEC") promulgated Rule 10b-5 which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

5. *Bryan*, 58 F.3d at 943.

of whether he owed any duties to the shareholders of the traded stock.' "[6] The Fourth Circuit, however, refused to uphold Bryan's conviction under the misappropriation theory.[7] The court did not base its decision on Bryan's failure to satisfy the elements of the theory,[8] but instead reasoned that behavior resulting in liability under the theory "does not constitute fraud in connection with the purchase or sale of securities, within the meaning of section 10(b)."[9] In reaching this conclusion, the Fourth Circuit examined the language and purpose of section 10(b) and Rule 10b-5, as well as Supreme Court cases interpreting these provisions.[10]

The *Bryan* decision is significant because the court refused to endorse a theory adopted by at least three other circuits.[11] The Supreme Court, which has never addressed the issue,[12] will now have to determine the validity of the misappropriation theory to restore consistency to the circuit courts' analysis of insider trading.

In response to *Bryan*, the *Harvard Law Review* published a Case Comment in its December 1995 issue[13] ("Harvard Comment") that criticized the *Bryan* decision and concluded that the Fourth Circuit "ultimately erred" in its conclusion.[14] The Harvard Comment posits that contrary to the *Bryan* court's reading of the Securities Exchange Act of 1934 ("Exchange Act"), the Supreme Court is not bound by the statutory text of the Exchange Act or applicable precedent if and when it examines the validity of the misappropriation theory.[15]

This Comment analyzes the *Bryan* decision and the Harvard Comment. Part I traces the common law development of insider trading liability under section 10(b) and Rule 10b-5, including the evolution of the misappropriation theory. This part focuses in particular on the genesis and development of the misappropriation theory in the Sec-

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6. *Id.* at 944 (quoting SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990)).

7. *Id.*

8. In fact, the *Bryan* court stated that "Bryan's conduct clearly constituted criminal activity under this theory of misappropriation." *Id.* at 945.

9. *Id.* at 952 (citation omitted).

10. *Id.* at 944.

11. *See* SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); United States v. Newman, 664 F.2d 12 (2d Cir. 1981). Whether the Third Circuit has adopted the misappropriation theory is open to debate. *See* United States v. Bryan, 58 F.3d 933, 943 n.5 (4th Cir. 1995) (citing Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985), *rev'd after remand*, 808 F.2d 252 (1986), *cert. denied*, 481 U.S. 1017 (1987)).

12. *See* Carpenter v. United States, 484 U.S. 19, 24 (1987) (affirming without opinion Carpenter's conviction based on misappropriation theory in an evenly divided Court); Chiarella v. United States, 445 U.S. 222, 235-36 (1980) (refusing to address government's argument based on misappropriation theory because issue was not properly charged to the jury).

13. *See Recent Case, Securities Law—Insider Trading—Fourth Circuit Rejects Misappropriation Theory of Rule 10b-5 Fraud Liability*, 109 Harv. L. Rev. 524, 536 (1995) [hereinafter *Recent Case*].

14. *Id.*

15. *Id.* at 538, 541.

ond Circuit. Part II examines in depth the *Bryan* decision and the rationale behind the Fourth Circuit's conclusion in that case. Part III analyzes the Harvard Comment and its arguments. In part IV, this Comment articulates why the misappropriation theory cannot find support in section 10(b), the legislative history of section 10(b), or Supreme Court precedent. Part IV also argues that the Second Circuit has been inconsistent in its application of the misappropriation theory, and that other alternatives exist to prevent misappropriation of material inside information. Finally, this Comment concludes that neither the language of section 10(b) and Rule 10b-5, nor Supreme Court precedent offer support for the misappropriation theory, and thus the Court should follow the Fourth Circuit's lead and invalidate the misappropriation theory as a basis for liability under section 10(b) and Rule 10b-5.

I. Historical Analysis of Section 10(b) Liability

Advocates of the misappropriation theory claim to find support for the theory under section 10(b) of the Exchange Act and Rule 10b-5. This part begins with an examination of these statutory provisions and their respective legislative histories. In addition, this part traces the development of insider trading liability under section 10(b) and Rule 10b-5 in early SEC administrative proceedings and in Supreme Court cases that address insider trading liability and general section 10(b) liability. Finally, this part examines the origin and development of the misappropriation theory in the Second, Ninth, and Seventh Circuits, prior to the *Bryan* decision.

A. *Securities Exchange Act of 1934*

Congress enacted the Securities Act of 1933 ("Securities Act") and the Exchange Act in response to the abuses that caused the stock market crash of 1929.[16] The Securities Act governs the initial distribution of securities, while the Exchange Act regulates the subsequent trading of issued securities.[17] Insider trading was one of the major abuses that Congress perceived as a cause of the 1929 crash.[18] Congress believed that fraudulent activities served no "useful economic function" and caused "great detriment to the investing public."[19] Prior to the crash, various state laws prohibited fraudulent concealment; Congress nonetheless believed that the problem of insider trading required a na-

16. C. Edward Fletcher, Materials on the Law of Insider Trading 45 (1991).
17. *Id.*; Louis Loss, Fundamentals of Securities Regulation 36 (2d ed. 1988).
18. Insider trading has been defined as "the purchase or sale of securities on the basis of material, non-public information." Fletcher, *supra* note 16, at 3. The Exchange Act does not contain a definition of insider trading. *See* 15 U.S.C. § 78a-*ll* (1994).
19. S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934).

tional solution.[20] Congress' concern with the dangers of insider trading when it enacted the Exchange Act demonstrates that the statute was, in part, an attempt to combat this abuse.[21]

While the legislative history and text of the Exchange Act indicate that Congress initially intended section 16[22] to combat insider trading,[23] section 10(b) subsequently became the most frequently used basis for establishing insider trading liability.[24] Section 10(b) of the Exchange Act makes it unlawful for anyone "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe."[25] Pursuant to the authority granted by section 10(b), the SEC established Rule 10b-5, which forbids anyone "[t]o engage in any act . . . which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."[26]

20. Fletcher, *supra* note 16, at 45 (noting that "many of the problems in the securities markets that were until [the crash] matters of state regulation were thought to be national problems requiring a national solution"). The need for national solutions arose from a belief that state blue sky laws varied widely from state to state and were therefore ineffective. *See* Michael E. Parrish, Securities Regulation and The New Deal 28-30 (1970). Further, it has been stated that prior to the enactment of federal securities laws, "insider trading was generally treated as an acceptable perquisite granted to corporate insiders." Nasser Arshadi & Thomas H. Eyssell, The Law and Finance of Corporate Insider Trading: Theory and Evidence 43 (1993).

21. *See* Fletcher, *supra* note 16, at 45 ("[W]ith the 1934 Act came an attempt by Congress to rid the markets of insider trading."); *see also* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 728 (1975) (describing the Exchange Act as "an Act 'to provide for the regulation of securities . . . to prevent inequitable and unfair practices . . . and for other purposes' " (citing 15 U.S.C. § 78a-*ll*)); Loss, *supra* note 17, at 36 (stating that the Exchange Act had as a theme the "prevention of fraud and market manipulation").

22. Section 16 of the Exchange Act: (1) requires that insiders, including directors and officers, of a company required to register under the Exchange Act file statements with the SEC describing any changes in their holdings in the company's stock; (2) makes short-swing profits recoverable by the firm; and (3) prohibits short selling by insiders of their own firms' shares. *See* 15 U.S.C. § 78p (1994).

23. Fletcher, *supra* note 16, at 45; *see also* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934) (stating that section 16 provides for "full and prompt publicity" to prevent abuse of insider information).

24. Fletcher, *supra* note 16, at 99 (noting that "the original statutory provision designed to deal with insider trading—section 16 of the 1934 Act— was (and is) useless in most cases because it is so underinclusive"); *see also* Arshadi & Eyssell, *supra* note 20, at 45 (stating that "limitations have made Section 16(b) a less than effective tool against insider trading"). Section 16 is limited in effectiveness because it is underinclusive in that it does not prohibit all forms of insider trading and overinclusive in that the "insiders" caught by the section include persons who are not trading on the basis of any inside information. *See* Fletcher, *supra* note 16, at 45-46.

25. 15 U.S.C. § 78j(b) (1994).

26. 17 C.F.R. § 240.10b-5(c) (1995). Twenty-five years after the promulgation of Rule 10b-5, Milton Freeman, one of its original drafters, remarked that the Rule was a combination of section 10(b) of the Exchange Act and section 17 of the Securities Act created in response to a question concerning what the Commission could do about the president of a company who was purchasing the company's stock while saying pub-

B. *Rule 10(b) Liability*

The SEC is responsible for enforcement of section 10(b) and Rule 10b-5 violations and may bring an administrative proceeding against violators or an injunctive proceeding in federal court.[27] This section reviews early attempts by the SEC to establish insider trading liability under section 10(b) and Rule 10b-5. This section then looks to the development of liability under section 10(b) in the Supreme Court both generally and specifically for insider traders.

1. Early Insider Trading Cases

In the seminal case of *In re Cady, Roberts & Co.*,[28] the SEC charged Cady, Roberts & Co., a broker-dealer,[29] and Robert Gintel, a selling broker and partner of Cady, Roberts, with violations of section 10(b) and Rule 10b-5.[30] In November 1959, J. Cheever Cowdin, a registered representative[31] associated with Cady, Roberts, attended a quarterly meeting of the directors of Curtiss-Wright.[32] At the meeting, the directors decided to cut the upcoming quarterly dividend by almost fifty percent per share compared with dividends the company paid in the previous three quarters.[33] The board then approved prompt disclosure of the dividend reduction.[34] Immediately upon leaving the directors meeting, Cowdin called the Cady, Roberts offices and left a message for Gintel that Curtiss-Wright had cut its quarterly dividend.[35] After receiving the message, Gintel placed sell orders for 7000 shares of Curtiss-Wright stock.[36] Due to various delays, the public announcement concerning the dividend reduction did not appear

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licly that the company was performing poorly. *See Conference on Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 921-23 (1967). In the meeting to adopt Rule 10b-5 "[a]ll the commissioners read the rule and . . . tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' " *Id.* at 922.

27. Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1445 (1994).

28. 40 S.E.C. 907 (1961).

29. A "broker" is defined in the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4) (1994). A "dealer" is defined in the Exchange Act as "any person engaged in the business of buying and selling securities for his own account." 15 U.S.C. § 78c(a)(5) (1994). "The term 'registered broker or dealer' means a broker or dealer registered or required to register [under the Exchange Act]." 15 U.S.C. § 78c(a)(48) (1994).

30. *Cady, Roberts*, 40 S.E.C. at 908.

31. A "registered representative" is a person who is associated with a National Association of Securities Dealers, Inc. member firm. Pass Trak Series 7 Principles & Practices: General Securities Representative 291 (6th ed. 1991) [hereinafter Pass Trak].

32. *Cady, Roberts*, 40 S.E.C. at 909.

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

on the Dow Jones News Ticker Service and did not reach the New York Stock Exchange until after Gintel had placed his sell orders.[37]

The SEC found in an administrative proceeding that the actions of Gintel and Cady, Roberts violated section 10(b) and Rule 10b-5.[38] In so holding, the SEC stated that the prohibitions imposed by section 10(b) of the Exchange Act

> rest[ ] on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.[39]

Gintel had indirect access to the information concerning the reduction in Curtiss-Wright's dividend because of his relationship with Cowdin, who was an insider by virtue of his position as a director of Curtiss-Wright.[40] In addition, the information Gintel possessed was "clearly recognizable as having a direct effect on the market value of securities and the judgment of investors."[41] Because Gintel had engaged in a "purchase or sale of securities" using information not available to the general public, the SEC found that he violated section 10(b) and Rule 10b-5.[42]

The SEC's decision in *Cady, Roberts* established for the first time liability under Rule 10b-5 for individuals not classified as traditional insiders. The SEC used an "equal access to information" theory as the basis for such liability.[43] Under the traditional doctrine of Rule 10b-5 liability, " 'insiders,' (particularly officers, directors, or controlling stockholders)" have an affirmative duty to "disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment."[44] Gintel was not a traditional insider under these terms.[45] His partner, Cowdin, however, was, and

37. *Id.* The Secretary of Curtiss-Wright had attempted to deliver the announcement to the New York Stock Exchange by Western Union, but through some unknown mistake, Western Union did not deliver the telegram until almost an hour and a half after it was transmitted. *Id.*

38. *Id.* at 911.

39. *Id.* at 912 (footnote omitted).

40. *Id.*

41. *Id.* at 915.

42. *Id.* at 911. Because Gintel was a partner at Cady, Roberts, the court found the firm liable under the doctrine of respondeat superior. *See id.* ("We also find a similar violation by [Cady, Roberts], since the actions of Gintel, a member of registrant, in the course of his employment are to be regarded as actions of [Cady, Roberts] itself.").

43. *See id.* at 912.

44. *Id.* at 911 (citing Speed v. Transamerica Corp., 99 F.2d 808, 828-29 (D. Del. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798, 800 (E.D. Pa. 1947); *In re* Ward La France Truck Corp., 13 S.E.C. 373, 380-81 (1943)).

45. *Id.* at 912.

the SEC found that this relationship imposed a duty on both Gintel and Cady, Roberts to abstain from trading the stock before public disclosure of the information.[46]

The Second Circuit also explored the boundaries of liability under section 10(b) and Rule 10b-5 in *SEC v. Texas Gulf Sulphur Co.*[47] The SEC charged Texas Gulf Sulphur Co., as well as thirteen individuals, with violating section 10(b) and Rule 10b-5.[48] Texas Gulf owned land in Canada that contained significant mineral deposits.[49] Before the presence of minerals was announced to the public, corporate officers and directors bought large numbers of shares in the company.[50] Subsequent to the mineral discovery announcement, the price of Texas Gulf stock increased by at least 100%.[51] The directors and officers then sold their holdings at a substantial profit.[52]

The Second Circuit found that the officers' and directors' actions violated Rule 10b-5.[53] Citing *Cady, Roberts*, the *Texas Gulf Sulphur* court stated:

> The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public.[54]

Like the SEC in *Cady, Roberts*, the Second Circuit suggested that insider trading liability under Rule 10b-5 could be imposed on defendants who are not traditional insiders.[55] The court held that anyone possessing "material inside information" who failed to disclose such information to the investing public before trading or, if unable to disclose the information, failed to abstain from trading altogether, was subject to liability under Rule 10b-5.[56] In reaching this conclusion, the Second Circuit looked to the congressional intent underlying section 10(b) and stated:

> The core of Rule 10b-5 is the implementation of the [c]ongressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress

46. *Id.* at 912, 914.
47. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).
48. *Id.* at 839-41.
49. *Id.* at 843-44.
50. *Id.* at 846-47.
51. *Id.* at 847.
52. *Id.*
53. *Id.* at 863.
54. *Id.* at 848 (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)).
55. Rule 10b-5 is, of course, still applicable to traditional insiders. As the *Texas Gulf* court explicitly stated, "[T]he Rule is also applicable to one possessing the information who may not be strictly termed an 'insider' within the meaning of Sec. 16(b) of the Act." *Id.* at 848.
56. *Id.*

> that all members of the investing public should be subject to identical market risks .... Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.[57]

Thus, the Second Circuit adopted what became known as the "equal access" theory for interpreting section 10(b).

2. Supreme Court Treatment of Section 10(b), Rule 10b-5, and Insider Trading

The Supreme Court over the past thirty years has addressed insider trading liability under section 10(b) and Rule 10b-5, as well as other fraudulent activities which give rise to liability under these provisions. This section first highlights some important decisions that address fraudulent activities covered by section 10(b), other than insider trading, and that provide insight into the Court's interpretation of section 10(b). Additionally, this section examines closely the two instances to date in which the Supreme Court specifically addressed insider trading liability under section 10(b) and Rule 10b-5.

a. *Other Fraudulent Activities under Section 10(b)*

In *Blue Chip Stamps v. Manor Drug Stores*,[58] the Supreme Court touched on the issue of whether a private plaintiff had to be a "purchaser"[59] or "seller"[60] of securities as defined by the Exchange Act in order to recover in a Rule 10b-5 cause of action.[61] In finding that a plaintiff must occupy one of these roles,[62] the Court considered, among other things, the textual scheme of the Securities and Exchange Acts. The Court compared the text of section 10(b), which creates liability for fraud "in connection with the purchase or sale," with section 17(a) of the Securities Act, which creates liability for fraud "in the offer or sale."[63] The Court concluded that if Congress had wished to provide a remedy under section 10(b) for plaintiffs who had neither purchased nor sold securities, it knew how to do so, as evidenced by section 17(a).[64] The Court thereby laid the foundation for its eventual conclusion that only fraud that takes place in connection with the purchase or sale of securities falls within the scope of section 10(b).

57. *Id.* at 851-52.
58. 421 U.S. 723 (1975).
59. "Purchase" is defined in the Exchange Act as "any contract to buy, purchase, or otherwise acquire." 15 U.S.C. § 78c(a)(13) (1994).
60. "Sell" is defined in the Exchange Act as "any contract to sell or otherwise dispose of." 15 U.S.C. § 78c(a)(14) (1994).
61. *Blue Chip Stamps*, 421 U.S. at 725.
62. *Id.* at 754-55.
63. *Id.* at 733-34 (comparing 15 U.S.C. § 77q with 15 U.S.C. § 78j).
64. *Id.*

The Supreme Court considered the intent necessary for a Rule 10b-5 cause of action in *Ernst & Ernst v. Hochfelder*.[65] The Court held that absent an intent to deceive, manipulate, or defraud, a private cause of action for damages will not lie under Rule 10b-5.[66] *Ernst & Ernst* is significant because the Court examined for the first time the legislative history of section 10(b). In so doing, the Court determined that the section was a "catchall" provision intended by Congress " 'to deal with new manipulative [or cunning] devices.' "[67] The Court described the congressional objective underlying section 10(b) as the prevention of " 'manipulative and deceptive practices which . . . fulfill no useful function' and [the creation] of private actions for damages stemming from 'illicit practices,' where the defendant has not acted in good faith."[68]

The Court in *Santa Fe Industries v. Green*[69] again examined the scope of section 10(b) liability and addressed specifically what constitutes fraud under Rule 10b-5.[70] The Court began by reinforcing that "the starting point in every case involving construction of a statute is 'the language itself.' "[71] Finding that "[t]he language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception,"[72] the Court concluded that a section 10(b) or Rule 10b-5 claim can lie only for "manipulative or deceptive" conduct within the meaning of the statute.[73] According to the Court in *Santa Fe*, merely reckless statements will not subject a defendant to section 10(b) liability.

Thus, the Court then focused on whether the defendant's actions were either deceptive or manipulative. The Court determined that the defendant's conduct was not deceptive because it did not involve "deception, misrepresentation or nondisclosure."[74] In evaluating what constitutes manipulation, the Court stated that manipulation is " 'virtually a term of art when used in connection with securities markets' . . . [and] refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by arti-

65. 425 U.S. 185 (1976).

66. *Id.* at 193.

67. *Id.* at 203 (quoting Thomas G. Corcoran, spokesman for the Rule's drafters) (alteration in original).

68. *Id.* at 206 (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 6, 12-13 (1934)).

69. 430 U.S. 462 (1977).

70. *Id.* at 471.

71. *Id.* at 472 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 756 (1975) (Powell, J., concurring))).

72. *Id.* at 473.

73. *Id.* at 473-74.

74. *Id.* at 476.

ficially affecting market activity."[75] The Court concluded that the defendant's conduct did not fall within this category, and stated:

> Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this "term of art" if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as [here, where] the essence of the complaint is that shareholders were treated unfairly by a fiduciary.[76]

The Court addressed additional considerations,[77] but found that the text of section 10(b) was " 'sufficiently clear in its context' to be dispositive."[78] The Court in *Santa Fe* thus established the parameters of the "manipulative and deceptive" requirement of section 10(b).

In its most recent encounter with section 10(b), the Court in *Central Bank v. First Interstate Bank*[79] addressed "whether private civil liability under § 10(b) extends . . . to those who do not engage in the manipulative or deceptive practice but who aid and abet the violation."[80] The Court concluded that the statute does not encompass aiding and abetting liability for private plaintiffs, and 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."[81] In reaching this conclusion, the Court relied on its earlier cases which consistently hold that section 10(b) violations must be premised upon "the making of a material misstatement (or omission) or the commission of a manipulative act."[82] The Court in *Central Bank* thus reaffirmed its earlier commitment to the "manipulative or deceptive" parameters and the "in connection with" requirement of section 10(b) established by the Court in *Blue Chip* and *Santa Fe.*

75. *Id.* (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)). Match sales are a group of transactions arranged by an individual who sends numerous orders, some to buy and others to sell, simultaneously to different brokers who, without knowledge that simultaneous orders have been placed, execute the orders, thereby causing a superficial appearance of market activity. *See* Charles A. Dice, The Stock Market 423 (1926). Wash sales, by comparison, are transactions in which no change in ownership takes place, but where the buyer and seller agree to "exchange" the stock at an above market price, thus creating activity in the stock and making it appear more healthy. *See id.* at 421-22.

76. *Santa Fe Indus.*, 430 U.S. at 477.

77. Specifically, the Court considered the purpose of the Exchange Act and corresponding state law remedies. *See id.* at 477-79.

78. *Id.* at 477 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976)).

79. 114 S. Ct. 1439 (1994).

80. *Id.* at 1443.

81. *Id.* at 1448.

82. *Id.*

b. *Insider Trading Liability under Section 10(b)*

The Supreme Court first examined insider trading liability under Rule 10b-5 in *Chiarella v. United States*.[83] *Chiarella* concerned "whether a person who learns from the confidential documents of one corporation that it is planning an attempt to secure control of a second corporation violates § 10(b) . . . if he fails to disclose the impending takeover before trading in the target company's securities."[84] Vincent Chiarella, the defendant in the case, worked in the composing room of Pandick Press, a financial printer, and thus had access to corporate takeover bid documents from which he was able to ascertain the identities of target companies.[85] Chiarella purchased stock in the target companies, without disclosing his knowledge of the potential takeovers, and then sold the stock at a substantial profit after the takeover attempts were publicized.[86] Chiarella was subsequently indicted for violations of section 10(b) and Rule 10b-5 and convicted on all counts.[87] The Second Circuit affirmed these convictions.[88]

The Supreme Court, however, reversed Chiarella's convictions under section 10(b) and Rule 10b-5.[89] Justice Powell, writing for the majority, found that "one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so."[90] Such 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' " the two parties.[91] The Court reasoned that the application of a duty to disclose in these circumstances "guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information."[92]

The Court in *Chiarella* stated that the trial court and the Second Circuit failed to identify a relationship between Chiarella and the

83. 445 U.S. 222 (1980).

84. *Id.* at 224.

85. *Id.* Target companies are companies subject to potential merger or acquisition by another company. In *Chiarella*, the identity of the target companies were concealed by the use of blank spaces or false names in the places where the true names would be inserted on the night of the final printing. *Id.*

86. *Id.*

87. *Id.* at 225.

88. United States v. Chiarella, 588 F.2d 1358, 1373 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

89. *Chiarella*, 445 U.S. at 225.

90. *Id.* at 228.

91. *Id.* (quoting Restatement (Second) of Torts § 551(2)(a) (1976)) (alteration in original). Such relationships can include, among others: principal and agent, executor and beneficiary, banks and depositor, attorney and client, and partners. *See* Restatement (Second) of Torts § 551(2)(a) cmt. f (1976).

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

stock sellers that gave rise to a duty to disclose on Chiarella's part.[93] Chiarella was not an insider, nor had he received confidential information from the target companies. The Court reasoned that in order to find Chiarella liable under Rule 10b-5, it would have to "recogniz[e] a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."[94] In declining to recognize such a duty, the Court concluded:

> We see no basis for applying such a new and different theory of liability in this case. As we have emphasized before, the 1934 Act cannot be read " 'more broadly than its language and the statutory scheme reasonably permit.' " Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information. The contrary result is without support in the legislative history of § 10(b) and would be inconsistent with the careful plan that Congress has enacted for regulation of the securities markets.[95]

The *Chiarella* court thereby rejected the "equal access" theory adopted in *Cady, Roberts* and *Texas Gulf.*

Finally, the majority refused to address the government's "misappropriation theory" because the theory was not submitted to the jury.[96] The government had argued on appeal that Chiarella's breach of duty occurred when he traded based on information obtained by virtue of his position at the printer employed by the corporation.[97] The government contended that the misappropriation theory is valid because it is based on fraud committed against the corporation and the stock sellers.[98] The Court concluded, however, that because the jury had not received instructions regarding a duty to anyone other than the sellers, the Court could not speculate as to the existence of any other duty.[99]

The Court again addressed liability for insider trading under section 10(b) in *Dirks v. SEC.*[100] Raymond Dirks was an officer of a New York broker-dealer that specialized in the analysis of insurance company securities.[101] Dirks received information from a former officer of Equity Funding of America, an insurance and mutual fund com-

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93. *Id.* at 231-32.
94. *Id.* at 233.
95. *Id.* at 234-35 (citations omitted).
96. *Id.* at 236. For a complete discussion of the dissenting opinions in the case concerning the misappropriation theory, see *infra* notes 118-32 and accompanying text.
97. *Chiarella*, 445 U.S. at 235-36.
98. *Id.*
99. *Id.* at 236-37.
100. 463 U.S. 646 (1983).
101. *Id.* at 648.

pany, that Equity Funding's assets were grossly overstated due to fraudulent practices.[102] The former officer urged Dirks to disclose the fraud publicly.[103] Dirks did investigate the allegations, which later proved to be true, and throughout his investigation openly discussed the information he obtained with a number of clients.[104] These clients subsequently sold their shares of Equity Funding stock.[105]

The SEC charged Dirks in an administrative proceeding with aiding and abetting a fraud in violation of section 17(a) of the Securities Act, section 10(b) of the Exchange Act, and Rule 10b-5, for which he was found guilty.[106] In finding that Dirk's discussions concerning Equity Funding violated these provisions, the SEC concluded: " 'Where 'tippees'—regardless of their motivation or occupation—come into possession of material 'corporate information that they know is confidential and know or should know came from a corporate insider,' they must either publicly disclose that information or refrain from trading.' "[107] The District of Columbia Circuit affirmed the SEC's decision.[108]

The Supreme Court, however, reversed Dirk's convictions.[109] The Court, citing *Cady, Roberts* and *Chiarella*, began with the premise that an insider is liable for a failure to disclose material nonpublic information only when he has a duty to disclose such information, and that this duty arises only through an agency, fiduciary, or "trust and confidence" relationship.[110] The Court rejected the concept that "all trad-

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102. *Id.* at 649.

103. *Id.*

104. *Id.*

105. *Id.* Included in those who sold based upon Dirks' information were numerous investment advisors who liquidated at least $16 million in Equity Funding stock. *Id.*

106. SEC v. Dirks, 21 S.E.C. Dock. 1401 (1981), *aff'd*, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

107. Dirks v. SEC, 463 U.S. 646, 651 (1983) (quoting *Dirks*, 21 S.E.C. Dock. 1401, 1407 (1981) (footnote omitted) (quoting Chiarella v. United States, 445 U.S. 222, 230 n.12 (1980))). Tippees are persons who receive material inside information from a traditional insider, but have no fiduciary relationship with the corporation or its shareholders. *See id.* at 655.

108. Dirks v. SEC, 681 F.2d 824 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983).

109. *Dirks*, 463 U.S. at 652.

110. *Id.* at 654. Corporate officers and directors "have a fiduciary duty to promote the interests of the corporation," and not "play favorites among the shareholders." 1 William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors § 1-7, at 15, § 1-14, at 34 (5th ed. 1993); *see also* Gottlieb v. McKee, 107 A.2d 240, 243 (Del. Ch. 1954) (recognizing corporate officers' and directors' fiduciary duties to shareholders under Delaware corporations law); N.Y. Bus. Corp. Law § 717(a) (McKinney Supp. 1996) ("A director shall perform his duties as a director . . . in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances."). The Supreme Court did recognize, however, that under certain circumstances outsiders may become fiduciaries of the shareholders. *See Dirks*, 463 U.S. at 655 n.14 ("For such a duty to be imposed . . . the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.").

ers must enjoy equal information before trading,"[111] but found that tippees are not always free to trade on the basis of inside information.[112] According to the Court, tippees can assume an insider's duty to shareholders if the inside information is made available to them improperly.[113] Information is received "improperly" if conveyed by an insider in violation of that insider's fiduciary duty to the shareholders, and if the tippee knows or should know that a breach has occurred.[114] Thus, a duty under Rule 10b-5 on the part of a tippee results if an insider "has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."[115] In *Dirks*, the former director of Equity Funding did not violate any duty by disclosing the information concerning the alleged fraud; thus, Dirks could not have derivatively breached a duty.[116]

The decisions in *Chiarella* and *Dirks* demonstrate that the Court will not find liability for insider trading under section 10(b) and Rule 10b-5 absent a duty owed to the counterparty to the securities transaction at issue. The Court does not, however, limit liability to traditional insiders; outsiders who owe a fiduciary duty to shareholders and tippees who know or should know that their source has breached a fiduciary duty can be liable for trading on the basis of nonpublic information. Other outsiders, however, are not subject to liability.

C. *Development of the Misappropriation Theory*

Chief Justice Burger, in his dissent in *Chiarella v. United States*,[117] laid the groundwork for what was to become the misappropriation theory. This section first discusses the Chief Justice's opinion in *Chiarella*. This section then traces the adoption and development of the misappropriation theory in the Second Circuit. Finally, this section examines the development of the misappropriation theory in the Ninth and Seventh Circuits.

1. Chief Justice Burger's Dissent in *Chiarella*

The Supreme Court's decision in *Chiarella* marks the first time the misappropriation theory of insider trading received attention from the High Court. The *Chiarella* majority refused to address an argument that the government raised only on appeal—that Chiarella was liable

111. *Dirks*, 463 U.S. at 657.
112. *Id.* at 659.
113. *Id.* at 660.
114. *Id.*
115. *Id.*
116. *Id.* at 666-67.
117. 445 U.S. 222 (1980).

under the misappropriation theory—because the jury was not instructed as to this argument.[118]

Chief Justice Burger disagreed, stating in a dissenting opinion that the jury had received instructions on the misappropriation theory, and that he would have affirmed Chiarella's conviction on such grounds.[119] Chief Justice Burger noted that he "would read § 10(b) and Rule 10b-5 to encompass and build on this principle: . . . that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."[120] The Chief Justice reasoned that the language of both section 10(b) and Rule 10b-5, the history of the statute and the Rule, and the cases interpreting these provisions supported his conclusion.[121]

First, according to the Chief Justice, the broad language contained in section 10(b) and Rule 10b-5 supports the conclusion that an individual who misappropriates nonpublic information has an absolute duty to disclose or refrain from trading on that information.[122] The Chief Justice argued: "The very language of § 10(b) and Rule 10b-5 'by repeated use of the word "any" [was] obviously meant to be inclusive.' "[123]

Chief Justice Burger also noted that the history underlying section 10(b) and Rule 10b-5 supports the misappropriation theory because these antifraud provisions were intended to ensure fairness among investors[124] and to prohibit practices that serve no useful function.[125] Chief Justice Burger reasoned that, contrary to the "fairness" sought by Congress in enacting section 10(b), the misappropriator who purchases securities on the basis of material nonpublic information gains an unfair trading advantage.[126] As to Congress' desire to prohibit nonuseful practices, the Chief Justice noted that a misappropriator's trading serves no function other than to enrich the misappropriator.[127]

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118. *Id.* at 236-37.

119. *Id.* at 239 (Burger, C.J., dissenting). Justices Brennan, Blackmun, and Marshall agreed with the Chief Justice's approval of the misappropriation theory. *See id.* at 239 (Brennan, J., concurring) ("[A] person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities."); *id.* at 251 (Blackmun J. and Marshall J., dissenting) ("I would hold that persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities.").

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

121. *Id.* at 240-42.

122. *Id.* at 240-41.

123. *Id.* at 241 (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).

124. *Id.* (citing H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess. 91 (1975)).

125. *Id.* (citing S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934)).

126. *Id.*

127. *Id.*

In addition, Chief Justice Burger reasoned that the misappropriation theory "follows naturally" from the *Cady, Roberts* decision.[128] The Chief Justice recalled the two factors set forth in *Cady, Roberts*, namely " 'access . . . to information intended to be available only for a corporate purpose' . . . [and] the unfairness inherent in trading on such information."[129] Chief Justice Burger concluded that both *Cady, Roberts* factors are met whenever a party gains an informational advantage by unlawful means, and thus the misappropriation theory satisfies both factors.[130]

Finally, Chief Justice Burger noted that the misappropriation theory would not threaten "legitimate business practices" such as "warehousing" or analysis by market specialists.[131] The Chief Justice reasoned that such legitimate practices would not violate the misappropriation theory because while such practices involve trading on the basis of material nonpublic information, the information at issue is not unlawfully misappropriated for personal gain.[132]

2. Adoption and Development of the Misappropriation Theory in the Second Circuit

In *United States v. Newman*,[133] the government attempted to remedy the problem that led the Supreme Court to refuse to review the misappropriation theory in *Chiarella*. Two of the defendants in *Newman*, E. Jacques Courtois, Jr. and Adrian Antoniu, were employees of investment banking firms.[134] Between January 1973 and December 1978, Courtois and Antoniu stole confidential merger and acquisition information from their employers and conveyed the information to James Newman, a securities trader and manager at a brokerage firm.[135] Newman in turn passed on the information to two confederates.[136] Based on the information, Courtois, Antoniu, and Newman surreptitiously purchased stock in companies that were takeover and merger targets of clients of Courtois' and Antoniu's firms.[137] Newman and his coconspirators reaped substantial gains by selling the stock after public announcement of the takeovers and mergers.[138]

The SEC subsequently charged Newman with " 'aid[ing], participat[ing] in and facilitat[ing] Courtois and Antoniu in violating the fiduciary duties of honesty, loyalty and silence owed directly to the

128. *Id.*
129. *Id.* (quoting *In re* Cady, Roberts & Co., 40 S.E.C. 907, 912 (1961)).
130. *See id.* at 241-42.
131. *Id.* at 242.
132. *Id.* at 242-43.
133. 664 F.2d 12 (2d Cir. 1981).
134. *Id.* at 15.
135. *Id.*
136. *Id.*
137. *Id.*
138. *Id.*

[investment firms], and clients of those investment banks.' "[139] The indictment also charged that Newman committed fraud and deceit in connection with the purchase of securities on the investment banks, which, in turn, owed a fiduciary duty to the target companies and their shareholders.[140]

Thus, the Government properly presented the misappropriation theory at the trial level, enabling the Second Circuit to address the viability of the theory.[141] The Second Circuit determined that the "conduct as alleged in the indictment could be found to constitute a criminal violation of section 10(b) and Rule 10b-5 despite the fact that neither [the investment firms] nor their clients w[ere] at the time a purchaser or seller of the target company securities in any transaction with any of the defendants."[142] The court determined that Newman's actions constituted a violation of Rule 10b-5 because they were fraudulent, deceitful, and undertaken in connection with the purchase or sale of securities.[143]

The Second Circuit first noted that Rule 10b-5 makes "it unlawful for any person to engage in any act or practice which operates as a fraud or deceit upon any person 'in connection with the purchase or sale of any security.' "[144] The court then considered the requirement of "fraud and deceit" and concluded that it "need spend little time on the issue."[145] Citing Chief Justice Burger's dissent in *Chiarella*, the *Newman* court concluded that by misappropriating valuable nonpublic information which was confidentially entrusted to him, Newman defrauded the investment banks just "as surely as if [he] took their money."[146] The court then turned to the "in connection with the purchase or sale of securities" requirement under section 10(b). Reasoning that Newman's sole purpose in obtaining the nonpublic information was to purchase stock in companies that were the subjects of the misappropriated information, the court found "little merit" in the contention that Newman's fraud was not in connection with the purchase or sale of securities.[147] The Second Circuit therefore affirmed Newman's conviction.[148]

139. *Id.* at 16.

140. *Id.*

141. *Id.*

142. *Id.* (footnote omitted).

143. *See id.* at 16-19.

144. *Id.* at 16-17.

145. *Id.* at 17.

146. *Id.*

147. *Id.* at 18. The *Newman* court cited Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971), in which the Supreme Court construed the "in connection with" requirement to encompass any activities "touching" the sale of securities. United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981).

148. *Newman*, 664 F.2d at 16.

In *Moss v. Morgan Stanley, Inc.*,[149] the shareholder derivative lawsuit relating to the criminal proceeding in *Newman*, the Second Circuit again addressed, but this time declined to accept, the misappropriation theory of liability under section 10(b) and Rule 10b-5.[150] In November 1976, Warner-Lambert Company retained Morgan Stanley to advise it on a potential tender offer for Deseret Pharmaceuticals Company.[151] On November 30, 1976, Courtois informed Antoniu of the potential tender offer and urged him to purchase stock in Deseret.[152] Later that day, Antoniu informed James Newman of the impending tender offer and, pursuant to an agreement among the three men, Newman purchased nearly 12,000 shares of Deseret stock at twenty-eight dollars per share.[153] Michael Moss was among the individuals who sold Newman his Deseret stock for twenty-eight dollars per share on November 30.[154] On the following day, trading in Deseret stock was halted and remained suspended until Warner-Lambert announced a tender offer for thirty-eight dollars per share.[155] Moss subsequently sued Newman, alleging, inter alia, violations of section 10(b) and Rule 10b-5.[156]

The Second Circuit affirmed the district court's dismissal of the action for failure to state a claim for relief.[157] Moss had urged the court "to include the defendants in th[e] category of nontraditional 'insiders' and argued that they necessarily violated section 10(b) and rule 10b-5 by purchasing Deseret stock without publicly disclosing their knowledge of the impending tender offer."[158] The court rejected this contention.[159] In so doing, the court first dismissed the argument that Newman owed a duty of disclosure to Moss.[160] The court also rejected Moss' assertion that the Supreme Court's decision in *Chiarella* permitted a cause of action against anyone "who trades on the basis of nonpublic 'misappropriated' information."[161] In this regard, the court stated:

> In effect, plaintiff's "misappropriation" theory would grant him a windfall recovery simply to discourage tortious conduct by securities purchasers. Yet, the Supreme Court has made clear that section 10(b) and rule 10b-5 protect investors against *fraud*; they do not remedy every instance of undesirable conduct involving securities.

149. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).
150. *Id.* at 16.
151. *Id.* at 8.
152. *Id.*
153. *Id.*
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.* at 9.
158. *Id.* at 11.
159. *Id.* at 12.
160. *Id.* at 15.
161. *Id.*

> As defendants owed no duty of disclosure to plaintiff Moss, they committed no "fraud" in purchasing shares of Deseret stock.
>
> Moreover, the Court has refused to recognize "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information." . . . We find that plaintiff's 'misappropriation' theory clearly contradicts the Supreme Court's holding in both *Chiarella* and *Dirks* and therefore conclude that the complaint fails to state a valid section 10(b) or rule 10b-5 cause of action.[162]

The *Moss* court thereby rejected the interpretive approach to section 10(b) adopted in *Newman*, choosing instead to rely upon the majority decision in *Chiarella*, as well as *Dirks*, as the basis for its opinion.

In *SEC v. Materia*,[163] the Second Circuit again addressed the validity of the misappropriation theory and somewhat surprisingly, returned to its original support for the theory. Anthony Materia was an employee of a printer who specialized in financial documents.[164] Due to the extremely sensitive nature of many of the documents (i.e., tender offer documents), information regarding a company's identity was ordinarily omitted until immediately prior to the completion of the proposed deal, and thus an ordinary perusal of the documents "would not reveal the information sought to be guarded."[165] Nonetheless, in performing his job as a copyholder, Materia read drafts of documents aloud to a proofreader, thereby enabling him to discern the identities of four or more target companies.[166] Materia subsequently purchased stock in the target companies and then sold the stock for a substantial profit following public announcement of the takeovers.[167]

The SEC filed an enforcement action against Materia, alleging section 10(b) and Rule 10b-5 violations predicated upon "Materia's trading in securities on the basis of material nonpublic information . . . misappropriated from his employer and its clients."[168] In a nonjury trial, Materia was convicted, enjoined from further trading, and forced to disgorge almost $100,000 in profits.[169]

The Second Circuit affirmed Materia's conviction.[170] Citing *Newman*, the Second Circuit stated that "[t]he facts in the instant appeal are sufficiently similar to those in *Newman* for us to affirm on the authority of that precedent alone."[171] The court, however, decided to

162. *Id.* at 16 (citations omitted).
163. 745 F.2d 197 (2d Cir. 1984).
164. *Id.* at 199.
165. *Id.*
166. *Id.*
167. *Id.*
168. *Id.* at 199-200.
169. *Id.* at 200.
170. *Id.* at 204.
171. *Id.* at 201.

elucidate the bases for its holding "[t]o delineate the contours of what may still be perceived as a novel theory of liability."[172]

As in *Newman*, the court in *Materia* started with the premise that under section 10(b) it is " 'unlawful for any person . . . [t]o engage in any act . . . which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of securities.' "[173] Also as in *Newman*, the court had little trouble finding that misappropriation of material nonpublic information "falls squarely within" the fraud or deceit requirement of Rule 10b-5.[174]

The Second Circuit next addressed Materia's argument that in order to be actionable under section 10(b) and Rule 10b-5, fraud must be predicated on a duty to disclose. Here, the court relied on its previous decision in *Chiarella*, which held that "liability could be premised upon [the defendant's] having misappropriated . . . information from his employer and its clients."[175] Because the Supreme Court did not explicitly reject the misappropriation theory in *Chiarella*, the Second Circuit felt free to revive the theory.[176] Finally, the court addressed Materia's contention that his alleged fraud was not in connection with the purchase or sale of securities.[177] The court rejected this argument and stated that the requirement was met by the "self-evident nexus presented in this case."[178] Because it found that the government had proven all the elements required to establish Rule 10b-5 liability, the Second Circuit affirmed Materia's conviction.[179]

The Second Circuit next addressed the misappropriation theory in *United States v. Carpenter*,[180] and applied the theory to a situation where the trader's employer lacked a fiduciary relationship with the traded company. David Carpenter, a news clerk for the *Wall Street Journal*, worked with R. Foster Winans, who, as a reporter for the paper, sometimes wrote the *Journal*'s "Heard on the Street" column.[181] Carpenter and Winans, contrary to the known policies of the

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172. *Id.*

173. *Id.* (quoting 17 C.F.R. § 240.10b-5 (1984)).

174. *Id.* The Second Circuit stated, "Materia's theft of information was indeed as fraudulent as if he had converted corporate funds for his personal benefit." *Id.* at 201-02.

175. *Id.* at 202 (citing United States v. Chiarella, 588 F.2d 1358, 1364-69 (2d Cir. 1978), *rev'd on other grounds*, 445 U.S. 222 (1980)).

176. *Id.* at 203.

177. *Id.*

178. *Id.* The court stated clearly, "The information Materia stole has no value whatsoever except 'in connection with' his subsequent purchase of securities." *Id.*

179. *Id.* at 203-04.

180. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

181. *Id.* at 1026. The "Heard on the Street" column discussed positive and negative information concerning certain stocks and offered an opinion regarding investment in such stocks. *See* United States v. Winans, 612 F. Supp. 827, 830 (S.D.N.Y. 1985), *aff'd in part, rev'd in part*, 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).

paper, provided Kenneth Felis, a stockbroker, with information about particular securities prior to the scheduled appearance of such information in Winans' column.[182] Based on this information, Felis, through various accounts, traded stock in the companies mentioned in "Heard on the Street."[183] The scheme eventually netted Carpenter, Winans, and Felis almost $700,000 in profits.[184] All three individuals were later charged with violations of section 10(b) and convicted in a nonjury trial.[185] Thus, the Second Circuit had to determine on appeal whether section 10(b) and Rule 10b-5 imposes liability on one "who owe[s] to the corporation and its shareholders [no] fiduciary duty of abstention or disclosure."[186]

The Second Circuit held that section 10(b) and Rule 10b-5 could support such liability.[187] The court rejected the defendant's argument that the requisite breach of duty must relate to the corporations or shareholders whose stock the misappropriator purchased or sold in reliance on the misappropriated information and stated that the misappropriation theory "broadly proscribes the conversion by 'insiders' or others of material nonpublic information in connection with the purchase or sale of securities."[188] The court further posited that section 10(b) was "broad in scope, encompassing all 'manipulative and deceptive practices which have been demonstrated to fulfill no useful function.' "[189]

The court was also satisfied that Carpenter's actions met the "fraud and deceit," "upon any person," and "in connection with" requirements of Rule 10b-5.[190] In addressing these elements, the court first determined that Carpenter's activities were not so significantly different from those undertaken by the defendants in *Newman* and *Materia*, and thus constituted the requisite "fraud or deceit."[191] Next, the court determined that the fraud committed by Carpenter on the *Wall Street Journal* was inflicted "upon any person."[192] Finally, the court deduced that those "who purchased or sold securities [from the defendants] without the misappropriated information would not have purchased

182. *Carpenter*, 791 F.2d at 1026.
183. *Id.* at 1026-27.
184. *Id.* at 1027.
185. *Winans*, 612 F. Supp. at 850.
186. *Carpenter*, 791 F.2d at 1028-29.
187. *Id.* at 1029-31.
188. *Id.* at 1029 (citing SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984); United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981); SEC v. Musella, 578 F. Supp. 425, 438 (S.D.N.Y. 1984)).
189. *Id.* at 1030 (quoting *Materia*, 745 F.2d at 201 (quoting S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934))).
190. *See id.* at 1031-32.
191. *Id.* The court stated that "such conduct constituted fraud and deceit, as it would had Winans stolen material nonpublic information from traditional corporate insiders or quasi-insiders." *Id.* at 1032.
192. *Id.* at 1032.

or sold . . . had they had the benefit of that information," and therefore the "in connection with" standard was met.[193] The Second Circuit concluded that the defendants had a duty under section 10(b) and Rule 10b-5 to abstain from trading or to disclose the misappropriated information to those with whom they traded.[194] Because the defendants failed to do so, the court affirmed their convictions.

The Supreme Court granted certiori in *Carpenter*.[195] In its decision, however, the Court merely stated: "The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts."[196] Thus, the Supreme Court, presented with the perfect opportunity to evaluate the merits of the misappropriation theory, failed to address this very important issue.

In *United States v. Chestman*,[197] the Second Circuit, en banc, returned to the misappropriation theory and, for the first time, reversed a conviction under the theory.[198] Robert Chestman, a stockbroker, had a client, Keith Loeb, who wished to consolidate his holdings of Waldbaum, Inc. stock with those of his wife Susan.[199] Keith Loeb's wife was the granddaughter of Julia Waldbaum (a Waldbaum board member and mother of Waldbaum's president and controlling shareholder, Ira Waldbaum).[200] To facilitate trades in Waldbaum stock, Keith Loeb sent his wife's birth certificate to Chestman, which listed Shirley Waldbaum Witkin as Susan's mother.

In November 1986, Ira Waldbaum agreed to sell a controlling interest in the company to a competitor at a price of $50 per share.[201] Ira spoke of the impending buyout announcement to, among others, Shirley Witkin, who in turn told Susan Loeb.[202] Susan Loeb told her husband of the pending buyout and warned him, as she had been warned by her mother, not to relay the information to anyone because "it could possibly ruin the sale."[203] On the following day, Keith Loeb phoned Chestman, informed him of the impending sale of Waldbaum at "a 'substantially higher' price than its market value," and asked Chestman what he should do.[204] Chestman refused to advise Loeb, but proceeded to purchase for himself, over 10,000 shares of

193. *Id.*
194. *Id.* at 1034.
195. Carpenter v. United States, 479 U.S. 1016 (1986).
196. Carpenter v. United States, 484 U.S. 19, 24 (1987).
197. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).
198. *Chestman*, 947 F.2d at 571.
199. *Id.* at 555.
200. *Id.*
201. *Id.*
202. *Id.*
203. *Id.*
204. *Id.* Chestman, however, "denied having spoken to Loeb about Waldbaum stock on the day of the trades." *Id.*

Waldbaum stock that morning for under $26.00 per share.[205] Loeb later phoned Chestman again and placed an order to buy 1000 shares of Waldbaum stock.[206] At the close of trading for that same day, the tender offer was announced publicly, causing the stock price to rise to $49.00 per share on the following day.[207] The government, after an SEC investigation, indicted Chestman for violations of Rule 14e-3(a), Rule 10b-5, mail fraud, and perjury.[208] He was found guilty after a jury trial and he subsequently appealed.[209] A Second Circuit panel reversed Chestman's convictions,[210] and the court granted an en banc hearing.[211]

The Second Circuit affirmed Chestman's Rule 14e-3(a) and perjury convictions, but reversed his Rule 10b-5 and mail fraud convictions.[212] In examining the Rule 10b-5 violation, the court had to determine whether the misappropriation theory, "and its predicate requirement of a fiduciary breach," could be applied to the context of familial relationships.[213] The court first traced the history of traditional Rule 10b-5 liability and concluded that such liability attaches when one " 'fails to disclose material information prior to the consummation of a transaction . . . when he is under a duty to do so.' "[214] The court then considered the misappropriation theory, which requires only an act of fraud upon the source of the nonpublic information.[215] The court referred to this concept as the "fraud-on-the-source" theory of liability[216] and cautioned that such theory could extend Rule 10b-5 liability to the " 'whole corporate universe.' "[217]

In an attempt to limit the potential liability under the fraud-on-the-source theory, the Second Circuit looked closely at what constitutes a fiduciary or similar relationship. First, the court noted that a fiduciary duty cannot be imposed unilaterally, and that marriage, without more,

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205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.* at 556.

209. *Id.*

210. United States v. Chestman, 903 F.2d 75 (2d Cir. 1990).

211. United States v. Chestman, 947 F.2d 551, 556 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

212. *Chestman*, 947 F.2d at 554.

213. *Id.* at 564.

214. *Id.* at 565 (quoting Chiarella v. United States, 445 U.S. 222, 228 (1980)).

215. *Id.* at 566. The court noted that it had previously applied the theory only in the employment context, while district courts in the Second Circuit had applied the theory to other relationships, including a psychiatrist/patient relationship and a father/son relationship. *Id.* (citing United States v. Willis, 737 F. Supp. 269 (S.D.N.Y. 1990); United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985)).

216. *Id.* at 567.

217. *Id.* (quoting United States v. Chiarella, 588 F.2d 1358, 1377 (2d Cir. 1978) (Meskill, J., dissenting) (quoting Santa Fe Indus. v. Green, 430 U.S. 462, 480 (1977)), *rev'd*, 445 U.S. 222 (1980))).

cannot give rise to a fiduciary relationship.[218] Second, the court recognized that certain relationships are "inherently fiduciary," including attorney/client, executor/heir, principal/agent, and senior corporate official/shareholder.[219]

Because the relationships between Keith and Susan Loeb, and between Keith Loeb and the Waldbaums, did not constitute any of these "inherently fiduciary" relationships, the court next considered whether either of the relationships constituted a "similar relationship of trust and confidence."[220] The court first established that this "similar relationship" must be the functional equivalent of a fiduciary relationship, which exhibits two principal characteristics—"dependence and influence."[221]

In evaluating the relationships at issue in *Chestman*, the court determined that neither constituted a similar relationship of trust and confidence.[222] As to the Keith Loeb/Waldbaum family relationship, the court found that the evidence failed to show "influence or reliance of any sort," and thus failed to demonstrate a fiduciary relationship.[223] The court also found that the relationship between Susan and Keith Loeb did not reach fiduciary status because Keith did not explicitly or implicitly accept a duty of confidentiality when Susan conveyed to him the misappropriated information.[224] Because Keith Loeb had not committed "a predicate act of fraud," Chestman could not be liable as a tippee.[225] The court therefore reversed Chestman's conviction under Rule 10b-5.[226] In so doing, the court implicitly retreated from its expansive reading of section 10(b) in *Carpenter*. The court recognized that the misappropriation theory, if not constrained, could create liability upon an infinite class of individuals.[227]

In *United States v. Teicher*,[228] the Second Circuit returned to its expansive interpretation of section 10(b) addressing whether a causal connection is necessary to find 10b-5 liability under the misappropria-

218. *Id.* at 567-68.
219. *Id.* at 568.
220. *Id.*
221. *Id.* at 569.
222. *Id.* at 570-71.
223. *Id.* at 570.
224. *Id.* at 571.
225. *Id.*
226. *Id.* Notably, however, five of the justices dissented and argued that the existence of a familial relationship would in and of itself suffice for liability under the misappropriation theory. *See id.* at 579 (Winter, J., concurring in part and dissenting in part).
227. *Id.* at 567 (citing United States v. Chiarella, 588 F.2d 1358, 1377 (2d Cir. 1978) (Meskill, J., dissenting) (quoting Santa Fe Indus. v. Green, 430 U.S. 462, 480 (1977), rev'd, 445 U.S. 222 (1980))).
228. 987 F.2d 112 (2d Cir. 1993).

tion theory.[229] Victor Teicher, an arbitrageur,[230] received information from Michael David, an associate of the law firm of Paul, Weiss, Rifkind, Wharton & Garrison, concerning possible acquisitions by clients of the law firm.[231] In addition, Robert Salsbury, a financial research analyst in the arbitrage department of Drexel Burnham Lambert, Inc., provided Teicher with a copy of the Drexel "phantom list," which listed companies potentially subject to mergers or takeovers by Drexel clients.[232] Based on this information, Teicher traded the stock of various companies and netted profits of over $100,000.[233]

The SEC investigated Teicher's activities and indicted him for conspiracy to commit securities fraud, mail fraud, and fraud in connection with a tender offer.[234] A jury convicted Teicher, who subsequently appealed, arguing, inter alia, that the district court improperly charged the jury as to the elements of his securities fraud charge.[235] Specifically, Teicher contended that the jury instructions erroneously stated that he could be convicted "based upon the mere possession of fraudulently obtained material nonpublic information without regard to whether this information was the actual cause of [his] sale or purchase of securities."[236]

The Second Circuit upheld Teicher's convictions, but ultimately skirted the issue of whether causation is in fact a necessary element for liability under the misappropriation theory of Rule 10b-5 liability.[237] The court did, however, express its support of the "knowing

229. *Id.* at 119.

230. "Arbitrage is a trading strategy used by specialized traders (called arbitrageurs) to profit from temporary price differences in between markets or securities." Pass Trak, *supra* note 31, at 115. There are three types of arbitrage: market arbitrage, where arbitrageurs take advantage of differences in a security's price in two different markets; security arbitrage, where arbitrageurs take advantage of differences in the prices of equivalent securities; and risk arbitrage, where arbitrageurs take advantage of potential takeover situations that cause fluctuations in stock prices. *See id.*

231. *Teicher*, 987 F.2d at 114-15.

232. *Id.* For interesting accounts of alleged insider trading by persons connected with Drexel Burnham Lambert, Inc., see Fenton Bailey, Fall From Grace: The Untold Story of Michael Milken (1992) (recounting the events surrounding the prosecution of Drexel "junk bond king" Michael Milken for securities fraud); Jesse Kornbluth, Highly Confident: The Crime and Punishment of Michael Milken (1992) (same); Dennis B. Levine & William Hoffer, Inside Out: A True Story of Greed, Scandal, and Redemption (1991) (describing in an autobiography the insider trading activities of Dennis Levine, a former Drexel managing director).

233. *Teicher*, 987 F.2d at 115-17. Teicher bought and sold stock in Avondale Mills, Allegheny International, American Brands, Revco, Republic Airlines, Westchester Financial Services Corporation, and Warnaco, Inc. *See id.*

234. *Id.* at 118.

235. *Id.*

236. *Id.* at 119.

237. *Id.* at 121. The court found that "it [was] unnecessary to determine whether proof of securities fraud requires a causal connection, because any alleged defect in the instruction was harmless beyond doubt." *Id.*

possession" standard advanced by the government,[238] suggesting that numerous factors led to this conclusion. First, the court held that the "in connection with" requirement of section 10(b) and Rule 10b-5 should be construed broadly, a view which supports the "knowing possession" standard.[239] Second, the court stated that the "knowing possession" standard is consistent with the tenet that "a tippee aquire[s] the same duty as his fiduciary tipper."[240] The court noted that because an insider must disclose nonpublic material information or abstain from trading if in "knowing possession" of material nonpublic information, the same duty should apply to the tippee.[241] Third, the court noted that the standard is "simple" because it recognizes that one who possesses inside information has an "informational advantage over other traders."[242] Finally, the court suggested that public policy supports the "knowing possession" standard because it allows effective enforcement of the securities laws.[243]

In its most recent encounter with the misappropriation theory in *United States v. Libera*,[244] the Second Circuit addressed the issue of whether a tipper must know that his breach of duty will lead to a tippee's trading on the misappropriated information in order for Rule 10b-5 liability to attach.[245] Diana Dillon was an employee of R.R. Donnelley & Sons Co., the printer of *Business Week* magazine.[246] Contrary to Donnelley's policy, but after official publication of the magazine, Diana would bring home copies of *Business Week* to her husband William.[247] After tracking the stocks of companies discussed in the magazine's "Inside Wall Street" column and realizing the potential for making money from trading in these stocks, William Dillon sought out William Cobb and eventually William Sady, both Donnelley employees, and convinced them to bring him copies of "Inside Wall Street" on Thursday mornings, prior to *Business Week*'s official

238. *Id.* at 120-21. "[T]he government advances the view, which has been consistently endorsed by the SEC, that a violation of § 10(b) and Rule 10b-5 occurs when a trade is conducted in 'knowing possession' of material nonpublic information obtained in breach of a fiduciary or similar duty." *Id.* at 120 (citing Sterling Drug Inc. Investigation, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,570 at 80,298 (Apr. 18, 1978)). An insider trader satisfies the "knowing possession" standard, according to the SEC, if when the insider sells his securities, he is in possession of material nonpublic information such that he is taking advantage of his position. *See id.* (quoting *Sterling Drug*, ¶ 81,570 at 80,298).

239. *Id.* (citing United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981) ("[T]he 'in connection with' clause must be 'construed . . . flexibly to include deceptive practices "touching" the sale of securities' "), *cert. denied*, 464 U.S. 863 (1983))).

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.* at 121.

244. 989 F.2d 596 (2d Cir.), *cert. denied*, 114 S. Ct. 467 (1993).

245. *Id.* at 597.

246. *Id.* at 597-98.

247. *Id.* at 598.

publication.[248] Dillon subsequently approached Brad Libera and told him of his money-making scheme. After informing Libera that Donnelley employees were forbidden to remove copies of the magazine from the plant, Dillon enlisted Libera in helping him to obtain copies of the column.[249] From 1986 to 1987, Libera executed sixty-four "Thursday trades" on the basis of the "Inside Wall Street" column, earning him a total profit of $95,000.[250] Francis Sablone, an attorney, frequently learned of Libera's inside information from either Libera or their mutual stockbroker.[251] Sablone also traded regularly in the stock of companies mentioned in the column, earning a total profit of $36,000.[252] Libera and Sablone were each indicted for, and subsequently convicted on, inter alia, numerous counts of securities fraud under section 10(b).[253]

In reviewing these convictions, the Second Circuit determined that knowledge by the tipper of a tippee's intent to trade on the misappropriated information was not a necessary element for section 10(b) liability.[254] Citing *United States v. Chestman*, the court stated that the misappropriation theory consists of two elements: "(i) a breach by the tipper of a duty owed to the owner of the nonpublic information; and (ii) the tippee's knowledge that the tipper had breached the duty."[255] The court noted that the imposition of a requirement of knowledge by the tipper of the tippee's intent to trade would result in the creation of a loophole in the law, given the difficulty of proving such knowledge "to a jury's satisfaction."[256] Finally, the court concluded that sufficient evidence established that: (i) the misappropriated information was material and nonpublic; (ii) the employees of Donnelley had breached a fiduciary duty to their employer; and (iii) Libera and Sablone knew that the Donnelley employees had breached such fiduciary duty.[257] The court thus affirmed Libera's and Sablone's convictions.[258]

3. The Ninth Circuit and the Misappropriation Theory

The Ninth Circuit was the next circuit to address the misappropriation theory. In *SEC v. Clark*,[259] the defendant, John Clark, was president of a company that produced and sold medical supplies.[260] Clark

248. *Id.*
249. *Id.* at 598-99.
250. *Id.* at 599.
251. *Id.*
252. *Id.*
253. *Id.* at 597.
254. *Id.* at 600.
255. *Id.* (citing United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992)).
256. *Id.* at 600.
257. *Id.* at 600-02.
258. *Id.* at 602.
259. 915 F.2d 439 (9th Cir. 1990).
260. *Id.* at 441.

was also a member of the company's acquisition team, which the company had established "to keep an eye out for appetizing takeover targets."[261] Through a fellow member of the acquisition team, Clark learned that the company was planning to purchase Affiliated Health Products for approximately thirty-five dollars per share.[262] Upon learning this information, Clark bought 3000 shares of stock in Affiliated Health, an act he attempted to conceal from his employer.[263] Subsequent to a public announcement of the acquisition, Clark sold his shares and netted almost $50,000 in profit.[264] Clark was indicted for, and later convicted by a jury on, Rule 10b-5 violations based on the misappropriation theory.[265]

The Ninth Circuit, in an attempt to discern whether the misappropriation theory is encompassed under Rule 10b-5 and authorized under section 10(b), first traced the development of the caselaw interpreting section 10(b).[266] The court noted that two theories of Rule 10b-5 liability had evolved.[267] First, "the classical theory" provides that

> "a person violates Rule 10b-5 by buying or selling securities on the basis of material 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."[268]

Second, the misappropriation theory imposes liability on one who "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock."[269] The court then traced the development of the misappropriation theory in the Second Circuit and concluded that the "thought that has gone into the misappropriation theory is considerable, and the consistency with which it has been applied is impressive."[270] Nonetheless, the Ninth Circuit examined the legislative and administrative underpinnings of the theory.

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261. *Id.*
262. *Id.*
263. *See id.* at 441-42.
264. *Id.* at 442.
265. *Id.*
266. *Id.* at 443-48.
267. *See id.* at 443-44.
268. *Id.* at 443 (quoting Barbara B. Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 Hofstra L. Rev. 101, 101-02 (1984)).
269. *Id.*
270. *Id.* at 448.

The court first acknowledged that Rule 10b-5 is a "catchall" provision.[271] The court then examined whether the misappropriation theory falls within the "fraud" concept of section 10(b) and Rule 10b-5, and determined that it does so "comfortably."[272] Next, the court considered the "in connection with" requirement of section 10(b) and Rule 10b-5 and concluded that denying a connection between a misappropriation and any subsequent trading would be "disingenuous."[273] Finally, the court looked to the legislative history of section 10(b) and Rule 10b-5, as well as subsequent legislative history, and concluded that the history provides "strong evidence that the misappropriation theory is compatible with the broad language of th[e] provisions."[274] The court thus endorsed the misappropriation theory. Because Clark's actions fell clearly within the ambit of the theory, the court upheld his conviction.[275]

4. The Misappropriation Theory in the Seventh Circuit

In *SEC v. Cherif*,[276] the Seventh Circuit became the third circuit court to grapple with the misappropriation theory. In what the court described as a "simple, cunning scheme," Danny Cherif, an ex-em-

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271. *Id.*

272. *Id.* at 449. In so doing, the court looked at interpretations of mail fraud and wire fraud statutes for guidance and found that the misappropriation of information amounts to fraud under these statutes. *Id.* at 448-49. Finding no reason not to apply the expansive meaning of fraud found in the mail and wire statutes in the securities context, the court decided that the mere misappropriation of material inside information could be considered "fraudulent" as required under section 10(b) and Rule 10b-5. *Id.* at 449.

273. *Id.* Here the court framed the question as "whether there is some nexus between Clark's misappropriation of [the company's] confidential information and any securities transactions." *Id.* The court stated that because Clark's sole purpose in obtaining the nonpublic information was to profit by trading on such information, it had "little trouble" concluding that Clark's actions were "in connection with" the purchase or sale of securities. *Id.*

274. *Id.* at 453. Although the court began by admitting that the legislative history of section 10(b) is " 'bereft of any explicit explanation of Congress' explicit intent,' " *id.* at 450 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976)), it concluded that the history evinces a broad purpose of protecting the public. *See id.* The court also traced the background of Rule 10b-5's adoption. In examining Milton Freeman's description of Rule 10b-5's passage, the court admitted that it would be "disingenuous" to posit that the SEC could have "sanctioned or even fores[een] the use of the misappropriation theory," *id.* at 451 (citing Remarks of Milton Freeman, *Conference on the Codification of the Federal Securities Laws*, 22 Bus. Law. 793, 922 (1967)), but concluded that the SEC was empowered to draft a rule which addressed "unforeseen species of fraud." *Id.* Finally, the court inquired into the subsequent legislative history of section 10(b) and Rule 10b-5 by examining the legislative history of the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, and the Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677, and concluded that Congress expressed a clear belief that the misappropriation theory was consistent with section 10(b) and Rule 10b-5. SEC v. Clark, 915 F.2d 439, 452-53 (9th Cir. 1990).

275. *Clark*, 915 F.2d at 449, 454.

276. 933 F.2d 403 (7th Cir. 1991) (en banc), *cert. denied*, 502 U.S. 1071 (1992).

ployee of First National Bank of Chicago, used his identification card to gain access to the bank's building on nights and weekends for over a year after his termination.[277] Cherif thus had access to information from the department of the bank that provided financing for tender offers and leveraged buyouts.[278] On the basis of this information, Cherif traded in the stock of four companies through two brokerage accounts, and realized profits of almost $250,000.[279] The SEC investigated Cherif, and with the help of a coworker, learned of Cherif's trading activities.[280] The district court, upon application by the SEC, issued a temporary restraining order and an injunction against Cherif, who subsequently appealed.[281]

The Seventh Circuit adopted the misappropriation theory, after tracing its development, and stated:

> We join [the Second and Ninth Circuits] in holding that a person violates Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934 by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment. There is a common sense notion of fraud behind the misappropriation theory.... 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.[282]

The court then turned to Cherif's argument that he in particular lacked the fiduciary duty necessary for liability under the misappropriation theory because he owed no duty to his former employer when he misappropriated the information.[283] The Seventh Circuit rejected this argument, stating that a common law duty "obligates an employee to protect any confidential information entrusted to him by his employer during his employment."[284] The court found that Cherif breached a continuing duty to his former employer when he used his identification card, in addition to information gained as an employee, to misappropriate information about upcoming transactions.[285] The court therefore held that Cherif's conduct was fraudulent in violation of Rule 10b-5.[286]

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277. *Id.* at 406.
278. *Id.*
279. *Id.* at 406-07.
280. *Id.*
281. *Id.* at 407.
282. *Id.* at 410.
283. *Id.* at 411.
284. *Id.*
285. *Id.*
286. *Id.* at 412. The Seventh Circuit reaffirmed its commitment to the misappropriation theory in SEC v. Maio, adopting the rationale applied in the *Cherif* case. *See* SEC v. Maio, 51 F.3d 623, 630-638 (7th Cir. 1995).

II. THE *BRYAN* CASE

In *United States v. Bryan*,[287] the Fourth Circuit addressed for the first time the validity of the misappropriation theory. The court refused to adopt the theory despite previous acceptance by other circuit courts, reasoning that the theory fails to comport with the text of section 10(b) and Rule 10b-5.[288] This part examines the facts of *Bryan*, as well as the analysis used by the Fourth Circuit in reaching its decision.

A. *Facts of the Case*

The Governor of West Virginia appointed Elton Bryan as the director of the West Virginia Lottery in April 1990.[289] Bryan's duties included negotiating and securing contracts on behalf of the lottery.[290] In the summer of 1991, the lottery began to investigate the possibility of expanding its video lottery gaming.[291] At a meeting in July 1991, high level officials in the Governor's administration (including Bryan) decided to proceed with the expansion of video lottery, but also decided to wait until after the anticipated reelection of the Governor in November 1992.[292] After several video lottery manufacturing companies learned of the July 1991 meeting, they began to lobby for a portion of the anticipated business.[293] One of these companies, Video Lottery Consultants ("VLC"), ultimately gained favor with the Governor and his administration.[294] In exchange for locating a manufacturing plant within the state, VLC would receive an exclusive contract to provide video lottery gaming terminals.[295] Bryan undertook to ensure that the Lottery Commission would in fact award such a contract to VLC.[296]

From August 1992 until November 1992, a number of meetings took place between VLC, Bryan, and the Deputy Director of the Lottery to negotiate the terms of the contract.[297] In September 1992, Bryan purchased 300 shares of VLC stock.[298] In November 1992, the Governor was reelected. Soon thereafter the Lottery Commission voted in favor of expanding the state's video lottery program and ordered the establishment of an investigative committee to determine the best method for the state to proceed with the program.[299] Bryan then re-

287. 58 F.3d 933 (4th Cir. 1995).
288. *Id.* at 944.
289. *Id.* at 937.
290. *Id.*
291. *Id.* at 938.
292. *Id.*
293. *Id.*
294. *Id.*
295. *Id.*
296. *Id.*
297. *Id.* at 938-39.
298. *Id.* at 939.
299. *Id.*

quested, without the Lottery Commission's knowledge, the issuance of a Request for Proposals which he had drafted previously in anticipation of this chain of events.[300] In response to the Request, VLC and International Game Technology, a rival of VLC, submitted packages.[301] Despite the formation of an evaluation committee, Bryan ensured that the committee would rate the VLC bid most favorably.[302]

Bryan was subsequently indicted and charged with wire fraud and mail fraud violations, securities fraud in violation of section 10(b) and Rule 10b-5 under the misappropriation theory, and perjury for falsely testifying before a grand jury.[303] A federal jury convicted Bryan on all counts and he appealed these convictions to the Fourth Circuit.[304]

B. *The Fourth Circuit's Opinion*

In a unanimous decision, the Fourth Circuit affirmed Bryan's mail fraud, wire fraud, and perjury convictions, but reversed his section 10(b) and Rule 10b-5 convictions.[305] In reversing the securities fraud convictions, the Fourth Circuit determined 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."[306]

The *Bryan* court first looked to the text of section 10(b) and Rule 10b-5 and determined that the language of both "sweeps broadly."[307] The court also noted that "[a]bsent guidance from the Supreme Court, the language of the Rule, if not of the statute, could plausibly accommodate the misappropriation theory."[308] Nonetheless, the *Bryan* court suggested that Supreme Court cases decided in the past two decades warn against expanding the concept of fraud in securities "beyond what the words of the [Exchange] Act reasonably will bear."[309] With this admonition in mind, the court then evaluated the misappropriation theory.[310]

The court began its evaluation with the concept that manipulation and deception are the touchstones of liability under section 10(b).[311]

300. *Id.*
301. *Id.*
302. *Id.*
303. *See id.* at 936.
304. *Id.*
305. *See id.*
306. *Id.* at 944.
307. *Id.* at 945.
308. *Id.*
309. *Id.* (citing Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1446 (1994); Chiarella v. United States, 445 U.S. 222 (1980)).
310. *Id.*
311. *Id.* (" 'The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception.' " (quoting Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977))).

The court determined that "manipulation" is virtually a term of art in the securities context which specifically refers to " 'practices, such as wash sales, matched orders, or rigged prices' " intended to affect market activity artificially by misleading investors.[312] The court thus limited the scope of its analysis to a determination of whether the misappropriation theory falls under the Rule 10b-5 prohibition against "fraud." The court also noted that "fraud" can encompass no more than the section 10(b) prohibition of "deception."[313] The court then defined "deception" as a "material misrepresentation or omission."[314]

The Fourth Circuit next turned to another tenet of the Supreme Court's interpretation of section 10(b): "[T]hat the principal concern of section 10(b) is the protection of purchasers and sellers of securities."[315] Citing *Chiarella v. United States*[316] and *Dirks v. SEC*,[317] the *Bryan* court concluded that a duty to disclose or abstain from trading arises only from an affirmative duty to disclose which in turn arises only out of a relationship of trust between parties to a transaction, and not merely because of a party's possession of nonpublic information.[318] In fact, "where the Court has not expressly limited the scope of the statute to frauds upon purchasers or sellers, it has, for the most part, described the statute as reaching no further than to frauds upon investors."[319] Finally, the *Bryan* court suggested that the only persons other than purchasers or sellers who may come within the purview of section 10(b) are those "closely linked to securities transactions."[320] Such persons include potential share purchasers, current shareholders who choose not to buy or sell based on material misrepresentations or omissions, and creditors, shareholders, or those who have a relationship with the issuer who suffer a loss in investment value because of insider activities.[321]

On the basis of the Supreme Court's interpretations of section 10(b) in *Chiarella* and *Dirks*, the Fourth Circuit concluded that the misappropriation theory was invalid. In reaching this conclusion, the court stated:

312. *Id.* at 945-96 (quoting *Santa Fe Indus.*, 430 U.S. at 476).
313. *Id.* at 946.
314. *Id.*
315. *Id.* at 946-47.
316. 445 U.S. 222 (1980).
317. 463 U.S. 646 (1983).
318. United States v. Bryan, 58 F.3d 933, 947 (4th Cir. 1995). The *Bryan* court also read the *Blue Chip* decision as supporting its "purchasers and sellers" premise. *Id.* at 948. "As the [*Blue Chip*] Court explained in reaching its holding, the language of section 10(b) would 'surely [be] badly strained [if] construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large.' " *Id.* (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 n.5 (1975)).
319. *Id.* at 948 (citing Dirks v. SEC, 463 U.S. 646, 663 n.23 (1983); Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1446 (1994); Santa Fe Indus. v. Green, 430 U.S. 462, 476-77 (1977)).
320. *Id.*
321. *Id.* (citing *Blue Chip*, 421 U.S. at 737-38).

> In light of the Court's consistent interpretation of section 10(b) as proscribing only the deception, by material misrepresentation or omission, of a purchaser or seller of securities, or of a person in some way connected with or having a stake in an actual or proposed purchase or sale of securities, we believe that the misappropriation theory cannot be defended.[322]

The court reasoned that while the misappropriation of information may involve "deception" in a generalized sense, it will not in most cases constitute a "misrepresentation" or "nondisclosure."[323] Furthermore, the Fourth Circuit reasoned, the misappropriation theory creates liability upon "the mere breach of a fiduciary relationship or similar relationship of trust and confidence."[324] Thus, the theory is not consistent with the Supreme Court's holding in *Santa Fe Industries v. Green*,[325] which requires deception in addition to a breach of fiduciary duty for liability under section 10(b).[326]

The Fourth Circuit went on to note that even if deception were not a requirement for liability under the misappropriation theory, the theory would still fail to meet the "in connection with a purchase or sale of securities" requirement of section 10(b).[327] According to the court, "the theory effectively eliminates the requirement that a person in some way connected to a securities transaction be deceived, allowing conviction not only where the 'defrauded' person has no connection with a securities transaction, but where no investor or market participant has been deceived."[328] The court stated:

> In allowing the statute's unitary requirement to be satisfied by any fiduciary breach (whether or not it entails deceit) that is followed by a securities transaction (whether or not the breach is of a duty owed to a purchaser or seller of securities, or to another market participant), the misappropriation theory transforms section 10(b) from a rule intended to govern and protect relations among market participants who are owed duties under the securities laws into a federal common law governing and protecting any and all trust relationships. If, as the Supreme Court has held, the fraud-on-the-market theory is insupportable because section 10(b) does not ensure equal information to all investors, . . . *a fortiori* such a general fraud-on-the-source theory in pursuit of the same parity of information cannot be defended.[329]

322. *Id.* at 949.
323. *Id.*
324. *Id.*
325. 430 U.S. 462 (1977).
326. United States v. Bryan, 58 F.3d 933, 949 (4th Cir. 1995) (citing *Santa Fe Indus.*, 430 U.S. at 473-74).
327. *Id.* (footnote omitted).
328. *Id.* at 950.
329. *Id.* (citation omitted).

Thus, the court concluded that the misappropriation theory fails to meet the "in connection with" requirement of section 10(b).[330]

Although the *Bryan* court found that the text of section 10(b) provides a sufficient basis to reject the misappropriation theory, the court went further in its analysis and stated that "the principles that inform interpretation of the securities fraud provisions also counsel rejection of the theory."[331] The court emphasized that the Supreme Court has repeatedly stated that the certainty and predictability of the securities market is served by clearly defined rules.[332] The court reasoned that absent this predictability, investors will find themselves "pawns" in an SEC litigation strategy of which they have no knowledge.[333] The court noted that application of the misappropriation theory brings uncertainty into the securities market because it requires only the breach of any fiduciary duty.[334] Fiduciary duties, the Fourth Circuit stated, are often difficult to ascertain, and no court since the inception of the misappropriation theory has offered a principled basis for determining which fiduciary relationships give rise to Rule 10b-5 liability.[335]

The court next reasoned that the rejection of the misappropriation theory would not have a "notable impact" on efforts to combat fraud in the securities markets.[336] First, the Fourth Circuit pointed to the fact that much of the conduct covered under the misappropriation theory is criminalized under section 10(b) as interpreted in *Dirks* and *Chiarella*.[337] After the *Dirks* decision, traditional insiders, temporary insiders (such as underwriters, accountants, and lawyers), and tippees of either group are subject to a duty to disclose nonpublic information or abstain from trading.[338] Second, the court reasoned that persons who are not liable under section 10(b) after *Dirks* will most likely be subject to liability under mail and wire fraud statutes.[339] The court referred to the Supreme Court's decision in *United States v. Carpenter*,[340] which split equally over the defendant's securities conviction

330. *Id.*
331. *Id.*
332. *Id.* at 950-51.
333. *Id.* at 951.
334. *Id.*
335. *Id.* The *Bryan* court stated: "[T]he only guidance that the Second Circuit has been able to provide, apart from its observation that the misappropriation theory rests on general notions of 'dependency and influence,' is that it 'will not apply outer permutations of chancery relief in addressing' whether a fiduciary duty or similar relationship of trust and confidence has been breached." *Id.* (citations omitted) (citing United States v. Chestman, 947 F.2d 551, 569, 570 (2d Cir. 1991)). In examining the case law addressing the misappropriation theory, the *Bryan* court concluded that if one attempted to formulate an applicable rule relating to fiduciary duty, the scope of such rule would be extremely broad. *Id.*
336. *Id.* at 953.
337. *Id.*
338. *Id.*
339. *Id.* (citing 18 U.S.C. §§ 1341, 1343, 1346).
340. 484 U.S. 19 (1987).

under section 10(b), but unanimously affirmed his conviction for violations of the wire fraud statute.[341] Third, the *Bryan* court noted that conduct not covered under section 10(b) or the mail and wire fraud statutes "will in many instances give rise to criminal and civil liability under the array of state laws addressing fraud and unethical conduct."[342]

Finally, the Fourth Circuit traced the evolution of the misappropriation theory in the Second Circuit and commented that the "somewhat harrowing" development appeared as "almost a testament to the theory's invalidity."[343] The *Bryan* court looked at the *United States v. Newman*,[344] *Moss v. Morgan Stanley, Inc.*,[345] and *SEC v. Materia*[346] holdings and noted the apparent inconsistency in the Second Circuit's endorsement of the theory.[347] The court then examined the Second Circuit's decision in *United States v. Chestman*[348] and found that the *Chestman* court could not "square the misappropriation theory with the Supreme Court's holdings in *Santa Fe Industries*, *Chiarella*, and *Dirks*, and [the *Chestman* court,] not surprisingly, realized that the misappropriation theory was neither necessary, defensible under precedent, susceptible in principle to limitation, nor justifiable on the strength of the broad purposes of the [Exchange] Act."[349] The Court also noted that even the *Chestman* dissenters, who advocated the adoption of the "misappropriation theory, were unable to identify a credible legal basis for the theory."[350]

The *Bryan* court ultimately concluded:

> [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

341. United States v. Bryan, 58 F.3d 933, 953 (4th Cir. 1995) (citing *Carpenter*, 484 U.S. at 24, 28).

342. *Id.*

343. *Id.*

344. 664 F.2d 12 (2d Cir. 1981).

345. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

346. 745 F.2d 197 (2d Cir. 1984).

347. United States v. Bryan, 58 F.3d 933, 953-57 (4th Cir. 1995). Specifically, the court recognized that despite the fact that the Second Circuit adopted the misappropriation theory in *Newman*, it subsequently rejected the theory in *Moss*, only to resurrect the theory again in *Materia*. *Id.*

348. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

349. *Bryan*, 58 F.3d at 958.

350. *Id.* at 959. The court addressed Judge Winter's dissent in *Chestman*, stating that Winter "admitted that 'any obvious relationship [between the misappropriation theory and] Section 10(b) is presently missing.' " Id. (alteration in original) (citing United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part), *cert. denied*, 503 U.S. 1004 (1992)).

> prohibited by section 10(b) of the Securities Exchange Act of 1934.[351]

In light of all these considerations, the Fourth Circuit rejected the misappropriation theory.

III. The Harvard Comment

In its December 1995 issue, the *Harvard Law Review* published a Case Comment in response to the Fourth Circuit's *Bryan* opinion.[352] The Harvard Comment argues that "the [Bryan] court ultimately erred in concluding that the text of [section 10(b)] and the applicable Supreme Court precedent could not support the [misappropriation] theory."[353] Despite its ardent disapproval of the *Bryan* decision, the Harvard Comment's ultimate conclusion is merely that while no court "*must* give effect to the misappropriation theory," courts *should* do so.[354]

The Harvard Comment first attacks the *Bryan* decision by stating that contrary to the *Bryan* court's interpretation, the misappropriation of material information does in fact meet the "misrepresentation or nondisclosure" requirement enunciated by the Supreme Court in *Santa Fe Industries v. Green*.[355] Underlying the misappropriation theory is the rationale that a person who misappropriates information from another party does so by breaching a fiduciary duty arising out of a relationship of trust and confidence between the parties.[356] The Harvard Comment describes the relationship as follows:

> [B]y entering into a fiduciary relationship, a person "implicitly stat[es] that she will not divulge or use to her own advantage information entrusted to her in the utmost confidence" and therefore she "deceives the other party by playing the role of the trustworthy employee or agent" and "defrauds it by actually using the stolen information to its detriment."[357]

The Harvard Comment argues that the misappropriation of nonpublic information meets the misrepresentation requirement by violating a continuing 'tacit' representation of confidentiality. Alternatively, the misappropriation of material inside information satisfies the nondisclosure requirement because such action constitutes a breach of the duty to an employer not to trade on the basis of confidential information without consent.[358]

351. *Id.*
352. *Recent Case*, *supra* note 13.
353. *Id.* at 536.
354. *Id.* at 541.
355. *Id.* at 537-39 (citing Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977)).
356. *Id.* at 539 (citing SEC v. Clark, 915 F.2d 439, 447-48 (9th Cir. 1990)).
357. *Id.* (quoting *Clark*, 915 F.2d at 448) (alteration in original).
358. *Id.*

The Harvard Comment also contends that the *Bryan* court was incorrect in its finding that the misappropriation theory is at odds with the Supreme Court's suggestion in *Santa Fe Industries* that " '[n]ot "all breaches of fiduciary duty in connection with a securities transaction" ... come within the ambit of Rule 10b-5.' "[359] The Harvard Comment retorts that the breach of a duty accompanied by appropriate factual disclosure "even if in connection with the buying or selling of securities" would not be actionable under the misappropriation theory.[360]

Moreover, the Harvard Comment urges that the Fourth Circuit was mistaken in its conclusion that the misappropriation theory is inconsistent with prior Supreme Court precedent interpreting the "in connection with" requirement of Rule 10b-5.[361] According to the Harvard Comment, applicable Supreme Court decisions have not limited Rule 10b-5 actions only to fraud committed against sellers or buyers of securities and others closely related to such buyers and sellers.[362] The Harvard Comment acknowledges that the Court's decision in *Blue Chip Stamps v. Manor Drug Stores*[363] might suggest the contrary position, but reminds the reader that "the Court also unmistakingly emphasized the fact that the entire Rule 10b-5 private cause of action was solely a judicial creation, and that the decision to limit its range was thus largely a matter of judicially determined policy."[364] The Harvard Comment reasons that *Blue Chip* thus does not foreclose the use of the misappropriation theory as a predicate for potential criminal liability or liability in an SEC enforcement action.[365]

The Harvard Comment next posits that "[a] strong argument may be made that the misappropriation theory . . . serve[s] broad public interest functions," and thus should fall within the ambit of section 10(b).[366] While it recognized that previous Supreme Court decisions suggest that the protection of purchasers and sellers of securities is the principal concern of section 10(b), the Harvard Comment notes that the Court has never held this concern out as the sole purpose of the statute.[367] The Harvard Comment argues that, in fact, the Court could not reach this conclusion because the explicit language of the

359. *Id.* (quoting United States v. Bryan, 58 F.3d 933, 946 (4th Cir. 1995) (quoting Dirks v. SEC, 463 U.S. 646, 654 (1983) (citing *Santa Fe Indus.*, 430 U.S. at 472))).

360. *Id.*

361. *Id.*

362. *Id.* at 539-40.

363. 421 U.S. 723 (1975).

364. *Recent Case, supra* note 13, at 540 (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)). The Harvard Comment finds that it was "quite odd" for the *Bryan* court to have even relied upon *Blue Chip* to determine the meaning of section 10(b), because the *Blue Chip* Court made it clear that the text of the statute was not the basis for its decision. *Id.* at 540 n.28 (citing *Blue Chip*, 421 U.S. at 737).

365. *Id.* at 540.

366. *Id.* at 541.

367. *Id.*

statute forbids such a finding.[368] Moreover, the Harvard Comment posits that Supreme Court precedent has recognized a broad purpose underlying section 10(b).[369] The Harvard Comment argues that the misappropriation theory falls within this broad purpose because the theory helps "assure would-be investors of the fairness of the market or [protects] property rights in information."[370]

Based on these findings, the Harvard Comment concludes that the *Bryan* decision may further the development of insider trading jurisprudence by pushing the Supreme Court to decide the merits of the misappropriation theory. If the Court does address the theory, however, the Harvard Comment urges, "[c]ontrary to *Bryan*'s claims, neither the statute nor previous decisions [would bind] the Court's hands."[371]

IV. The Indefensibility of the Misappropriation Theory

Should the Supreme Court accept the challenge, the Court must, contrary to the Harvard Comment's assertions, conclude that *United States v. Bryan*[372] was correct in finding that the misappropriation theory is invalid. The theory fails on several grounds. First, the text of section 10(b) and Rule 10b-5 do not support liability based on the misappropriation theory. Second, the legislative history of the Exchange Act does not evince a congressional intent in favor of the theory. Third, use of the misappropriation theory contravenes Supreme Court precedent. Fourth, application of the misappropriation theory has been inconsistent and unpredictable. Finally, sufficient alternatives exist to capture the illegal behavior encompassed by the misappropriation theory. This part examines these various considerations in turn.

A. *The Misappropriation Theory Cannot Find Support within the Text of Section 10(b)*

The textual controversy surrounding the misappropriation theory essentially asks two questions. First, does the misappropriation of nonpublic information constitute a "manipulative or deceptive device" under section 10(b)?[373] Second, does the misappropriation theory comport with the "in connection with" requirement of section

368. *Id.*
369. *See id.* at 541 n.32 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 203 (1976)).
370. *Id.* at 541.
371. *Id.*
372. 58 F.3d 933 (4th Cir. 1995).
373. Section 10(b) states that it shall be illegal "[t]o use or employ, *in connection with* the purchase or sale of security . . . ." 15 U.S.C. § 78j(b) (1994) (emphasis added).

10(b)?[374] The *Bryan* court answered both questions in the negative. The Harvard Comment, however, argues that the misappropriation theory meets both of these requirements. This section examines the two questions in depth.

1. The Misappropriation Theory Does Not Require a "Manipulative or Deceptive" Act

Regulation of fraudulent behavior is the driving force behind section 10(b) and Rule 10b-5.[375] This fraudulent behavior may take the form of manipulation or deception.[376] The Supreme Court has deemed manipulation to be "a term of art,"[377] and "deception" to mean "a material misrepresentation or the material failure to disclose" information in violation of a duty to disclose.[378]

These definitions make clear that activities covered under the misappropriation theory are not of the type Congress intended to prohibit with the enactment of section 10(b). Manipulation refers to practices which artificially affect market activity.[379] Misappropriation of material nonpublic information and trading on such information involve no attempt to affect market activity artificially. A misappropriator is not attempting to create the appearance of market activity, but instead is seeking to profit personally by trading upon the misappropriated information. Further, the *Bryan* court determined that misappropriation does not constitute deception as defined by the Supreme Court.[380] The court concluded that "the misappropriation theory does not even require deception, but rather allows the imposi-

374. Section 10(b) forbids the use or employment of "any *manipulative or deceptive device* or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ." *Id.* (emphasis added).

375. *See* Chiarella v. United States, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catchall clause to prevent fraudulent practices."); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (holding that a private cause of action under section 10(b) will not lie absent an "intent to deceive, manipulate, or defraud"); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975) ("The wording of § 10(b) [is] directed at *fraud* . . . ." (emphasis added)).

376. *See* Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1446 (1994) ("In § 10(b), Congress prohibited manipulative or deceptive acts in connection with the purchase or sale of securities."); Dirks v. SEC, 463 U.S. 646, 654 (1983) (stating that manipulation or deception is a requirement of Rule 10b-5); Santa Fe Indus. v. Green, 430 U.S. 462, 473-74 (1977) ("Thus the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute."); Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971) ("[W]e read § 10(b) to mean that Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities . . . .").

377. *See Santa Fe Indus.*, 430 U.S. at 476 (" 'Manipulation' is 'virtually a term of art when used in connection with securities markets.' " (quoting *Ernst & Ernst*, 425 U.S. at 199)).

378. *Id.* at 474.

379. *See id.* at 476.

380. United States v. Bryan, 58 F.3d 933, 949 (4th Cir. 1995).

tion of liability upon the mere breach of a fiduciary relationship or similar relationship of trust and confidence."[381]

The Harvard Comment argues that the misappropriation of nonpublic information qualifies as both a misrepresentation and a nondisclosure, and thus constitutes deception in violation of section 10(b). The Harvard Comment, however, misses the mark. The misappropriation theory fails to meet either the misrepresentation or the nondisclosure standard for deception.

"Misrepresentation" was characterized by the Supreme Court in *Santa Fe Industries* as a "misstatement."[382] The misappropriation theory requires no such behavior.[383] A person is guilty of misappropriation when he "(1) misappropriates material non-public information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to shareholders of the traded stock."[384] Such violation, by definition, does not involve any affirmative "misstatement" on the part of the misappropriator, either to the person to whom he has breached a duty or to the person with whom he has traded. Thus, the Harvard Comment's suggestion that one may meet the misrepresentation requirement by violating a "continuing 'tacit' representation of confidentiality"[385] renders the requirement meaningless. This analysis might demonstrate the existence of a fiduciary duty between the misappropriator and the source of the information, but does nothing to prove that any affirmative "misstatement" by the misappropriator has taken place.

In the absence of a misstatement, liability must rest on the defendant's failure to disclose the nonpublic information. The Supreme Court squarely addressed the nondisclosure standard in *Chiarella v. United States*.[386] As the Court stated:

> [S]ilence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence *between parties to a transaction*.[387]

The misappropriation theory is not consistent with this definition of nondisclosure because the theory does not require the breach of a

381. *Id.*
382. *See* Santa Fe Indus. v. Green, 430 U.S. 462, 474 (1977).
383. *Bryan*, 58 F.3d at 949.
384. SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).
385. *Recent Case*, *supra* note 13, at 539.
386. 445 U.S. 222 (1980).
387. Chiarella v. United States, 445 U.S. 222, 230 (1980) (emphasis added); *see also* Dirks v. SEC, 463 U.S. 646, 654-55 (1983) (recognizing *Chiarella* as establishing a "requirement of a specific relationship between the shareholders and the individual trading on inside information").

duty existing between the parties to the transaction at issue. The suggestion that the misappropriator violates the nondisclosure requirement by breaching a duty owed to the source of the information rather than to his trading partner stands in direct conflict with the definition of nondisclosure set out in *Chiarella.*

Several circuit courts have held that the misappropriation theory comports with the "manipulative and deceptive" requirement of section 10(b), but these courts have provided little explanation for their findings. In *United States v. Newman,*[388] the first Second Circuit case to adopt the misappropriation theory, the court completely ignored the language of section 10(b) and instead looked to the language of Rule 10b-5 to determine that the requirement is not manipulation and deception, but rather "fraud and deceit."[389] The *Newman* court then stated that it "need spend little time on the issue [of fraud and deceit]" because the defendants had "defrauded [their] employers as surely as if they took their money."[390]

The *Newman* court's "fraud and deceit" standard was subsequently followed in other decisions. In *SEC v. Materia,*[391] the Second Circuit merely echoed *Newman* and stated that against the backdrop of the expansive meaning of "fraud or deceit," Materia's actions clearly qualified as fraudulent.[392] Moreover, in *United States v. Carpenter,*[393] the Second Circuit explained that the defendant had acted with the requisite "fraud and deceit" because his actions did not "significantly differ from the 'fraud and deceit' in *Newman* and *Materia.*"[394]

The Ninth and Seventh Circuits also have ignored Supreme Court precedent in their analysis of the section 10(b) and Rule 10b-5 fraud requirement. The Ninth Circuit looked to mail and wire fraud cases for guidance as to what constitutes "fraud."[395] The Seventh Circuit in *SEC v. Cherif*[396] stated that the defendant's "actions were fraudulent in the common understanding of the word because they deprived some person of something of value by 'trick, deceit, chicane or overreaching.' "[397]

The circuit court cases, while relying upon common understandings of fraud, fail to examine the Supreme Court's interpretation of the "manipulative and deceptive" requirement. The Court has specifically

388. 664 F.2d 12 (2d Cir. 1981).
389. *Id.* at 17.
390. *Id.*
391. 745 F.2d 197 (2d Cir. 1984).
392. *Id.* at 201.
393. 791 F.2d 1024 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).
394. *Id.* at 1031.
395. SEC v. Clark, 915 F.2d 439, 448-49 (9th Cir. 1990) (citing *Carpenter*, 484 U.S. at 27).
396. 933 F.2d 403 (7th Cir. 1991) (en banc), *cert. denied*, 502 U.S. 1071 (1992).
397. SEC v. Cherif, 933 F.2d 403, 412 (7th Cir. 1991) (quoting McNally v. United States, 483 U.S. 350, 358 (1987)), *cert. denied*, 502 U.S. 1071 (1992).

defined such terms, but the Second, Ninth, and Seventh Circuit cases make no attempt to square the misappropriation theory with the Court's definitions. The circuit court cases, therefore, have not adequately justified the misappropriation theory under the "manipulative and deceptive" requirement of section 10(b).

2. The Misappropriation Theory Is Inconsistent with the "In Connection With" Requirement

Even assuming that the misappropriation of material inside information constitutes deceptive behavior, the misappropriation theory must comply with another statutory requirement to be valid under section 10(b); the "manipulative or deceptive" act must take place "in connection with" the purchase or sale of securities.[398] The *Bryan* court concluded that the "in connection with" requirement of section 10(b) and Rule 10b-5 indicates that the statute and rule reach "only deception of persons with some connection to, or some interest or stake in, an actual or proposed purchase or sale of securities."[399] The court concluded that the mere misappropriation of material nonpublic information does not satisfy this standard because the " 'defrauded' person has no connection with a securities transaction."[400]

The Harvard Comment disagrees with this reasoning and argued that Supreme Court decisions have not left section 10(b) and Rule 10b-5 applicable only to fraud committed against purchasers and sellers of securities and persons closely related to such purchasers and sellers.[401] The Harvard Comment downplays the Court's holding in *Blue Chip Stamps v. Manor Drug Store*[402], which limited standing in 10(b) actions to purchasers and sellers of securities,[403] stating that the Court in that case ruled in the private action context and thus the Court's decision did not foreclose application of the misappropriation theory in a criminal or SEC enforcement proceeding.[404] Additionally, the Harvard Comment argues that because section 10(b) empowers

398. Section 10(b) states that "It shall be unlawful for any person . . . (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." 15 U.S.C. § 78j (1994). Rule 10b-5 imposes similar liability for engaging in practices "which operate[ ] or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. § 240.10b-5 (1995).

399. United States v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995). The *Bryan* court had established earlier that the "principal concern of section 10(b) is the protection of purchasers and sellers of securities," and thus a duty to disclose under section 10(b) can exist only when there is a duty between the two parties to the transaction. *Id.* at 946-47.

400. *Id.* at 950.

401. *Recent Case*, *supra* note 13, at 540.

402. 421 U.S. 423 (1975).

403. *See supra* notes 58-62 and accompanying text.

404. *Recent Case*, *supra* note 13, at 540.

the SEC to regulate practices " 'in the public interest or for the protection of investors,' " courts should not read the "in connection with" requirement constrictively.[405]

Again, however, the Harvard Comment misses the mark. The misappropriation of material nonpublic information, without more, does not come within the Court's construction of the requirement that the challenged conduct take place "in connection with" the purchase or sale of a security under section 10(b). In addition to *Blue Chip*, other cases demonstrate that the Court requires a duty between the parties to the securities transaction at issue, or between parties closely related the primary parties, in order to satisfy the "in connection with" language of the statute.[406] The misappropriation theory widens section 10(b)'s scope considerably by looking to relationships outside the securities transaction at issue. The misappropriation theory imposes liability based on the breach of a duty owed to the source of the information, not to the other party to the securities transaction.[407]

Moreover, the person from whom the information was appropriated is generally not closely related to the counterparty to the transaction. For example, as in *Cherif*, an individual who is a former employee of a bank can misappropriate information from the bank and trade on the basis of such information.[408] In such a case, the misappropriator deals fairly, or at least not fraudulently, with the other party to the transaction, while the bank has no relation whatsoever with the misappropriator's trading partner. As the *Bryan* court stated, 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."[409] Because the misappropriation theory ignores the "in connection with" requirement of section 10(b), the theory cannot serve as a basis for liability under the statute.

The circuit court cases that endorse the misappropriation theory have been less than thorough in their analyses of the "in connection with" requirement of section 10(b). The Second Circuit in *Newman* espoused a broad "touch test" requirement for section 10(b) liability and stated that because Newman's "sole purpose in participating in

405. *Id.* at 541 (quoting 15 U.S.C. § 78j(b) (1994)) (emphasis omitted).

406. *See* Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1446 (1994) (reaffirming that § 10(b) is not violated for nondisclosure absent an "independent duty of disclosure"); Dirks v. SEC, 463 U.S. 646, 655 (1983) (recognizing a "requirement of a specific relationship between the shareholders and the individual trading on inside information"); Chiarella v. United States, 445 U.S. 222, 230 (1980) (stating that "silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b) . . . [if it] is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction").

407. *See supra* note 6 and accompanying text.

408. *See supra* notes 277-79 and accompanying text.

409. United States v. Bryan, 58 F.3d 933, 950 (1995) (emphasis in original).

the misappropriation of confidential takeover information was to purchase shares of the target companies, we find little merit in his disavowal of a connection between the fraud and the purchase."[410] In *Materia*, the Second Circuit again summarily dismissed "[w]hatever limitations [were previously] . . . read into the 'in connection with' language," stating that "it is clear that the requirement is satisfied by the self-evident nexus presented in this case."[411] The Second Circuit in *Carpenter* found that the misappropriation theory is consistent with the "in connection with" requirement because the misappropriator's use of material inside information for financial gain, to the detriment of the investors with whom the misappropriator trades, supports such a conclusion.[412] The Ninth Circuit in *SEC v. Clark*,[413] echoing *Newman*, described the "in connection with" standard as requiring the fraud to "touch" upon the securities transactions at issue, and stated that "[t]o deny a connection between the misappropriation and the subsequent trading would be disingenuous."[414] The Seventh Circuit in *Cherif* found that the nexus between the defendant's trading activities and his misappropriation satisfied the "in connection with" requirement because "[h]is trades were 'in connection with' a fraudulent scheme to gain access to material, non-public information."[415]

Again, the circuit court cases ignore Supreme Court precedent concerning the "in connection with" requirement under section 10(b) and instead rely upon common sense notions including "nexus" and "touch." The Court has explicitly established that the "in connection with" language focuses on the parties to the transaction.[416] The Second, Ninth, and Seventh Circuits cases look beyond the trading parties and thus are unconvincing in their contention that the misappropriation theory meets the section 10(b) "in connection with" requirement.

B. *The Misappropriation Theory Does Not Comport with the Legislative History of Section 10(b)*

While Congress indisputably intended the Securities and Exchange Acts to eradicate insider trading, section 10(b) was not the provision originally intended to combat such abuses.[417] Instead, Congress enacted section 16(b) to address insider trading liability.[418] Furthermore, the legislative history of the Exchange Act demonstrates that Congress intended section 10(b) to control manipulative practices,

410. United States v. Newman, 664 F.2d 12, 18 (2d Cir. 1981).
411. SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984).
412. United States v. Carpenter, 791 F.2d 1024, 1032 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987).
413. 915 F.2d 439 (9th Cir. 1990).
414. *Id.* at 449.
415. SEC v. Cherif, 933 F.2d 403, 411 (7th Cir. 1991).
416. *See supra* note 312 and accompanying text.
417. *See supra* notes 18-23 and accompanying text.
418. *See supra* note 23 and accompanying text.

which do not include the mere misappropriation of nonpublic information in the absence of a duty to disclose such information.[419]

Congress enacted the Securities and Exchange Acts in part to combat the "unfair methods of speculation employed by large operators and those possessing inside information regarding corporate affairs."[420] Congress drafted section 16(b) to prevent the unfair use of information obtained by corporate insiders due to their relationships with issuers.[421] The misappropriation theory imposes liability on persons other than corporate insiders.[422] Thus, the theory extends well beyond the category of insider trading that Congress sought to prohibit under the Exchange Act.

Because section 16(b) did not succeed in preventing the misuse of nonpublic information by corporate insiders, courts began to use section 10(b) to address insider trading.[423] Whatever the validity of the section's application to traditional insiders, the employment of section 10(b) to reach beyond the variety of insider trading that Congress intended to combat with the Exchange Act is inappropriate.[424] The misappropriation theory uses section 10(b) to impose liability on a class of persons that Congress did not seek to "catch" with its enactment of the Exchange Act. Moreover, Congress originally intended section 10(b) to combat the use of manipulation, deception, or contrivances.[425] The Senate Report accompanying the Exchange Act defined such practices to include wash sales, matched orders, and other transactions specifically designed to manipulate the price of a security.[426] The misappropriation theory does not itself attempt the regulation of these practices. Thus, the theory is untenable in light of the legislative intent underlying the Exchange Act.

C. *The Misappropriation Theory Controverts Supreme Court Precedent*

The Harvard Comment argues that, should the Supreme Court have an opportunity to pass on the merits of the misappropriation theory, the Court will not be bound by its prior decisions in addressing the

419. *See supra* note 312 and accompanying text.
420. S. Rep. No. 792, 73d Cong., 2d Sess. 3 (1934).
421. *See* 15 U.S.C. § 78p(b) (1994).
422. *See* SEC v. Cherif, 933 F.2d 403, 406 (7th Cir. 1991) (ex-bank employee), *cert. denied*, 502 U.S. 1071 (1992); SEC v. Materia, 745 F.2d 197, 199 (2d Cir. 1984) (financial printer); Chiarella v. United States, 588 F.2d 1358, 1362 (2d Cir. 1978) (printer), *rev'd*, 445 U.S. 222 (1980).
423. *See supra* note 24.
424. *See* Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1453-54 (1994) ("Policy 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.").
425. *See* 15 U.S.C. § 78j(b) (1994).
426. *See* S. Rep. No. 792, 73d Cong., 2d Sess. 3-4 (1934).

validity of the theory.[427] The *Bryan* court conversely found that Supreme Court precedent concerning liability under section 10(b) would not support the misappropriation theory.[428] The Supreme Court, as the Fourth Circuit noted in *Bryan*, has formulated certain basic principles for interpreting section 10(b) and has established standards for insider trading liability under this provision.[429]

The Supreme Court has stated repeatedly that section 10(b) cannot be read more broadly than the text of the statute will allow.[430] Additionally, the Court has held that Rule 10b-5 cannot be read more broadly than section 10(b).[431] As noted earlier, the plain language of section 10(b) and Rule 10b-5 does not support the misappropriation theory.[432] Thus, the imposition of section 10(b) and Rule 10b-5 liability based on the misappropriation theory contravenes Supreme Court precedent.[433]

Further, the Court in *Chiarella* and *Dirks v. SEC*[434] specifically confronted the issue of insider trading liability under section 10(b).[435] In both cases the Court insisted that section 10(b) liability requires a duty to disclose on the part of the individual trading with knowledge of material inside information.[436] In *Chiarella*, where the actions of the defendant closely resembled what would normally create liability under the misappropriation theory,[437] the Court refused to affirm

427. *See Recent Case*, *supra* note 13, at 541 (stating that "[c]ontrary to *Bryan*'s claims, neither the statute nor previous decisions have bound the Court's hands," should the Court "pass upon the merit of the misappropriation theory").

428. United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995).

429. *See id.* at 945.

430. *See* Central Bank v. First Interstate Bank, 114 S. Ct. 1439, 1448 (1994) ("It is inconsistent with settled methodology in § 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text."); Chiarella v. United States, 445 U.S. 222, 234 (1980) ("As we have emphasized before, the 1934 Act cannot be read 'more broadly than its language and the statutory scheme reasonably permit.' " (internal quotations and citations omitted)). *But see* Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971) ("Section 10(b) must be read flexibly, not technically and restrictively.").

431. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976) (stating that the Commission's authority cannot extend the scope of the power granted to it by Congress under section 10(b)).

432. *See supra* part IV.A.

433. *See id.*

434. 463 U.S. 646 (1983).

435. *See generally* Dirks v. SEC, 463 U.S. 646 (1983) (reversing section 10(b) conviction of "tippee" for lack of duty to disclose or abstain from trading); Chiarella v. United States, 445 U.S. 222 (1980) (reversing section 10(b) conviction of printer for lack of duty to disclose or abstain from trading).

436. *See Dirks*, 463 U.S. at 654-55; *Chiarella*, 445 U.S. at 235.

437. *Compare Chiarella*, 445 U.S. at 224-25 (finding that Chiarella could not be charged with section 10(b) violations for trading on information regarding the names of potential target companies obtained while working for a printing company) *with* United States v. Libera, 989 F.2d 596, 597-99, 602 (2d Cir. 1993) (finding violations of section 10(b) for individuals who traded based upon information obtained from newspaper article prior to its publication), *cert. denied*, 114 S. Ct. 467 (1993).

Chiarella's conviction because he was not subject to an affirmative duty to disclose the nonpublic information in his possession.[438] The Court stated: "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic market information."[439] The Court reaffirmed that a duty to disclose is a prerequisite for liability to attach under section 10(b) in *Dirks*.[440] The *Dirks* Court held that in order for a tippee to be found liable under section 10(b), he must assume a fiduciary duty to the shareholders, which can arise only through a corporate insider's breach of his own fiduciary duty to the shareholders.[441]

The misappropriation theory fails to comply with the Court's requirement of a "duty to disclose" for section 10(b) liability. The misappropriation theory extends well beyond the violation of a direct duty to disclose, as the Court noted in *Chiarella*. For example, as in *Materia*, an individual who misappropriates information from a printer has no relationship with the party with whom he trades.[442] Further, the misappropriation theory sweeps more broadly than a tippee's duty to disclose, which the Court addressed in *Dirks*, because the theory imposes such secondary liability even where there is no initial breach of duty by an insider. As the *Chiarella* Court stated: "Formulation of . . . a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, . . . should not be undertaken absent some explicit evidence of congressional intent."[443] The misappropriation theory is an example of such a radical departure and is thus invalid.

D. *Application of the Misappropriation Theory in the Second Circuit Has Been Inconsistent and Unpredictable*

The *Bryan* court emphasized that "[i]t 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."[444] The court pointed to the Second Circuit's development of the misappropriation theory and posited that since the misappropriation theory's inception, no court has been able to establish a bright-line test distinguishing which breaches of fiduciary duty give rise to liability.[445] The Supreme Court in *Dirks* sug-

438. *Chiarella*, 445 U.S. at 233-35.
439. *Id.* at 235.
440. *Dirks*, 463 U.S. at 654-55.
441. *Id.* at 660.
442. *See supra* notes 164-67 and accompanying text.
443. Chiarella v. United States, 445 U.S. 222, 233 (1980).
444. United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995).
445. *Id.* The court cited cases that establish liability on bases such as the duties that exist between an employer and employee, an employee and his tippee, a newspaper and its reporters, and a husband and wife. *Id.* (citing United States v. Newman, 664

gested that "it is essential . . . to have a guiding principal for those whose daily activities must be limited and instructed by the SEC's inside-trading rules."[446] In light of the Second Circuit's inability to establish a bright-line test and consistently apply the misappropriation theory, subjecting individuals to liability on the basis of a shifting theory would be unfair.

Harmonization of the Second Circuit's decisions in *Newman*, *Moss v. Morgan Stanley, Inc.*,[447] and *Materia* is nearly impossible. In *Newman*, the Second Circuit adopted the misappropriation theory by relying upon a "fraud and deceit" standard and by using a "broad 'touch' test" to meet the "in connection with" requirement.[448] In *Moss*, however, where the same "fraudulent" activities as in *Newman* were at issue, the Second Circuit conversely recognized that the misappropriation theory fails to meet the "duty to disclose" requirement as set out in *Chiarella* and determined that the misappropriation theory would grant plaintiffs "a windfall recovery simply to discourage tortious conduct by securities purchasers."[449] In *Materia*, the Second Circuit relied upon the "windfall recovery" concept to justify its return to acceptance of the misappropriation theory by stating that "such analysis [as that in *Moss*] bears only on the type of question raised in a private suit for damages; it is not relevant to an inquiry into whether the Rule was or was not contravened."[450] This attempt to distinguish *Moss* is hollow. The *Moss* court invalidated the misappropriation theory in reliance upon the Supreme Court's decision in *Chiarella*, an SEC action, not a private suit for damages.[451] Thus, even the Second Circuit, the birthplace of the misappropriation theory, has been unable to adopt a consistent position concerning the validity of the theory. To rely upon these cases to support the misappropriation theory is to base an argument on shaky ground.

Furthermore, the Second Circuit's holding in *United States v. Chestman*[452] is difficult to square with the court's earlier decisions. In *Chestman*, the Second Circuit apparently retreated from its expansive endorsement of the misappropriation theory. The court acknowledged that the misappropriation theory cannot be squared with any previous form of section 10(b) liability.[453] The *Chestman* court stated that the misappropriation theory is a "second general theory of Rule

F.2d 12, 17 (2d Cir. 1981); United States v. Carpenter, 791 F.2d 1024, 1026 (2d Cir. 1986), *aff'd*, 484 U.S. 19 (1987); United States v. Chestman, 947 F.2d 551, 564 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992)).

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

447. 719 F.2d 5 (2d Cir. 1983), *cert. denied*, 465 U.S. 1025 (1984).

448. United States v. Newman, 664 F.2d 12, 17-19 (2d Cir. 1981).

449. *Moss*, 719 F.2d at 16.

450. SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984).

451. *Moss*, 719 F.2d at 16.

452. 947 F.2d 551 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

453. *See* United States v. Chestman, 947 F.2d 551, 566-67 (2d Cir. 1991) (en banc), *cert. denied*, 503 U.S. 1004 (1992).

10b-5 liability" which "does not require that the buyer or seller of securities be defrauded."[454] Further, the court recognized that it broke ranks with the traditional theory of insider trading liability in *Carpenter*, where "the defendants did not owe the people with whom they traded a duty to disclose or abstain from trading—absent resurrection of the twice rejected parity of information theory."[455]

The Second Circuit in *Chestman* also acknowledged that the misappropriation theory could lead to unbridled liability under section 10(b).[456] The court stated that while fiduciary/shareholder obligations "arise within a narrow, principled sphere," other fiduciary obligations under common law are "anything but clear."[457] Moreover, the court also acknowledged that its own precedents provide little guidance concerning breaches of fiduciary obligations outside of the employer/employee context.[458] Thus, the court concluded that it should "tread cautiously" in extending Rule 10b-5 liability," fearing that its decisions could "lose method and predictability."[459] The *Chestman* opinion thereby stands in stark contrast with the Second Circuit's other broad-based misappropriation theory decisions.

E. *Sufficient Alternatives Ensure Liability for Misappropriators*

The *Bryan* court noted that a rejection of the misappropriation theory would not significantly hinder efforts to combat securities fraud. First, the court reasoned that much of the criminal behavior that the misappropriation theory tries to combat falls within the Supreme Court's holdings in *Chiarella* and *Dirks*.[460] *Chiarella*, and more specifically *Dirks*, create liability for persons who would also be covered under the misappropriation theory. As the *Bryan* court stated: "After *Dirks*, corporate insiders, . . . and so-called temporary insiders, such as underwriters, accountants, lawyers, or consultants working for a corporation, are under a duty to disclose or abstain, as are tippees of either group."[461] Further, in *Chestman*, the Second Circuit acknowledged that the defendants in *Newman* and *Materia* would fall under the temporary insider liability established in *Dirks*.[462]

The *Bryan* court also suggested that persons not included under the *Chiarella* and *Dirks* umbrella of liability would be subject to sanctions under federal statutes prohibiting mail and wire fraud.[463] The Court

454. *Id.* at 566.
455. *Id.* at 567.
456. *See id.*
457. *Id.*
458. *Id.*
459. *Id.*
460. *See* United States v. Bryan, 58 F.3d 933, 953 (4th Cir. 1995).
461. *Id.* (citing Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983)).
462. United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).
463. *See Bryan*, 58 F.3d at 953.

in *Carpenter* created an expansive definition of "fraud" under the wire and mail fraud statutes that imposes liability in many instances where the behavior would not fall under the *Chiarella* or *Dirks* standards.[464] The Court defined fraud broadly to include activities that fall within the " 'common understanding' " of the word, " 'usually signify[ing] the deprivation of something of value by trick, deceit, chicane or overreaching.' "[465] This definition readily encompasses the type of behavior engaged in by misappropriators.

Finally, the *Bryan* court posited that many of the breaches covered by the misappropriation theory also give rise to liability under state laws concerning fraud and unethical conduct.[466] California, as well as other states, provide penalties for a person "whose relationship to the issuer gives him access, directly or indirectly, to material information about the issuer not generally available," and who purchases or sells a security knowing that such information "would significantly affect the market price of the security[,] . . . is not generally available to the public, and . . . is not intended to be so available, unless he has reason to believe that the person selling to or buying from him is also in possession of the information."[467] In addition, in New York, a jurisidiction in which a large number of cases addressing the misappropriation theory are litigated, the General Business Law establishes liability for any person who engages in "[a]ny fraud, deception, concealment, suppression, false pretense or fictitious or pretend purchase or sale."[468] The New York General Business Law also creates liability for any person who possesses material non-public information "relating to any takeover bid" obtained from an insider or "any other person acting on behalf of the offeror or target company" and who purchases, sells, or causes to be purchased or sold any security of such target company.[469]

Thus, while proponents of the misappropriation theory argue that use of the theory is necessary to combat insider trading, ample means

464. *See* Carpenter v. United States, 484 U.S. 19, 24, 28 (1987) (affirming unanimously Carpenter's convictions for federal mail and wire fraud, while affirming Carpenter's section 10(b) convictions by an equally divided court); *Bryan*, 58 F.3d at 943-44 (finding sufficient proof to support Bryan's wire fraud conviction for trading on confidential information, but rejecting liability under the misappropriation theory).

465. *Carpenter*, 484 U.S. at 27 (quoting McNally v. United States, 483 U.S. 350, 358 (1987) (quoting Hammerschmidt v. United States, 265 U.S. 182, 188 (1924))).

466. *Bryan*, 58 F.3d at 953.

467. Cal. Corp. Code § 25402 (West 1977). Four other states have identical or similar statutory provisions. *See* Iowa Code Ann. § 502.402 (West 1991); N.M. Stat. Ann. § 58-13B-32 (Michie 1991); Pa. Stat. Ann. tit. 70, § 1-406 (1994); S.D. Codified Laws Ann. § 47-31A-101(b) (1991).

468. N.Y. Gen. Bus. Law § 352-c(1)(a) (McKinney 1984). A New York court has interpreted such provision to encompass behavior similar to that which would establish liability under the misappropriation theory. *See* People v. Florentino, 116 Misc. 2d 692 (N.Y. Crim. Ct. 1982) ("There is no requirement under . . . § 352-c of the New York General Business Law that the victims of defendant's breach of confidence be sellers or buyers of securities.").

469. N.Y. Gen. Bus. Law § 1609(b) (McKinney 1984).

exist to ensure that those who have been injured by insider trading can seek redress in court. The misappropriator may have committed the type of behavior prohibited by *Chiarella* and *Dirks*. The misappropriator may be guilty of violations of federal mail or wire fraud as defined by the Court in *Carpenter*. Finally, the misappropriator may be liable under state law antifraud provisions.

Conclusion

In *United States v. Bryan*, the Fourth Circuit became the first circuit court to reject the misappropriation theory. The Fourth Circuit in rejecting the misappropriation theory did so in contravention of the adoption of the theory by three sister circuits, thereby creating uncertainty in federal securities law. The Supreme Court, not yet having addressed the validity of the theory, should, when presented with the opportunity to do so, restore consistency to this area of law. The Harvard Comment implicitly suggests that when the Court addresses the issue, it should endorse the misappropriation theory. This Comment, however, posits that the misappropriation theory is indefensible.

The misappropriation theory is invalid for a host of reasons. First, misappropriation does not constitute a "manipulative or deceptive" act as required by section 10(b). Second, the misappropriation theory fails to meet the "in connection with' requirement of section 10(b). These two grounds alone should be enough to invalidate the misappropriation theory, but other considerations also point to rejection of the misappropriation theory. The legislative history of section 10(b) does not support the application of the theory. In addition, the application of the misappropriation theory contravenes Supreme Court precedent. Finally, numerous alternative ways are available to punish misappropriators besides establishing liability under section 10(b). Given all these considerations, the Supreme Court should resolve the confusion created in the circuit courts by unambiguously rejecting misappropriation liability under section 10(b).