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EXTENDING OUTSIDER TRADING LIABILITY TO THIEVES

Adam R. Nelson*

This Note addresses the important question of whether all thieves can be held liable for violating section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Over time, the U.S. Supreme Court has cautiously expanded liability for trading on material nonpublic information from corporate insiders only, to tippees, to outsiders standing in a fiduciary relationship to the source of the confidential information. Recently, the Second Circuit held in SEC v. Dorozhko that a thief who owed no duty to the source of misappropriated information could be held liable if he accomplished his theft by means of affirmative misrepresentation. This decision represents the next step in increasing liability for outsider trading.

This Note contends that holding all thieves liable, even those who do not obtain information by means of affirmative misrepresentation, constitutes a logical expansion of liability consistent with section 10(b), Rule 10b-5, and case law. The traditional requirement of a fiduciary relationship between the misappropriator and the source of the information in outsider trading cases results in under-inclusive doctrine that fails to fully satisfy the purpose of the Exchange Act. Expanding liability to include all thieves is sound policy that will better protect investors and the integrity of the market.

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INTRODUCTION

On October 13, 2011, Raj Rajaratnam, the billionaire co-founder of the Galleon Group hedge fund, was sentenced to eleven years in prison for violating federal insider trading laws.¹ At Rajaratnam’s sentencing, Judge Richard Holwell commented, “Insider trading is an assault on the free markets,” and that Rajaratnam’s crimes “reflect a virus in our business culture that needs to be eradicated.”² Prosecutors accused Rajaratnam of exploiting a network of well-placed friends and business contacts to gain confidential information relating to earnings reports and takeover activities at a number of major companies, including Google, Hilton, and Intel.³ These tippers included a former managing director of McKinsey & Company, Rajat Gupta,⁴ and a senior vice president at IBM, Robert Moffat.⁵ In total, the government has brought charges against twenty-nine defendants in enforcement actions related to the Galleon investigation.⁶

The prosecution of Rajaratnam and the other members of his web of tippers indicates the seriousness with which the government pursues insider trading allegations and the stiff penalties imposed on those who are caught

1. Susan Pulliam & Chad Bray, *Trader Draws Record Sentence: Rajaratnam Slapped with 11-Year Prison Term for Orchestrating Insider Scheme*, WALL ST. J., Oct. 14, 2011, at A1.

2. Peter Lattman, *Galleon Chief Sentenced to 11-Year Term in Insider Case*, N.Y. TIMES DEALBOOK (Oct. 13, 2011, 11:18 AM), <http://dealbook.nytimes.com/2011/10/13/rajaratnam-is-sentenced-to-11-years/>.

3. See Litigation Release No. 21,284, SEC, SEC Charges 13 Additional Individuals and Entities in Galleon Insider Trading Case (Nov. 5, 2009), <http://www.sec.gov/litigation/litreleases/2009/lr21284.htm>.

4. See Complaint at 1, SEC v. Gupta, No. 11 Civ. 7566 (S.D.N.Y. Oct. 26, 2011). The complaint against Gupta alleged that he shared with Rajaratnam information obtained in the course of his duties as director of Goldman Sachs and Proctor & Gamble. *Id.*

5. See James Bandler, *Dangerous Liaisons at IBM: How a Star Executive’s Love Affair Ensnared Him in the Biggest Hedge Fund Insider-Trading Ring Ever*, FORTUNE, July 26, 2010, at 66, 68; Caroline Winter et al., *The Great Hedge Fund Takedown*, BLOOMBERG BUSINESSWEEK, Mar. 14–20, 2011, at 79, 80.

6. See Litigation Release No. 22,140, SEC, SEC Files Insider Trading Charges Against Rajat Gupta, Brings New Charges Against Raj Rajaratnam (Oct. 26, 2011), <http://sec.gov/litigation/litreleases/2011/lr22140.htm>.

engaging in the practice.⁷ For the first time in an insider trading investigation, the government used wiretaps to record conversations during which Rajaratnam and others shared information.⁸ The eleven-year sentence Rajaratnam received, though less than the maximum twenty-four years' imprisonment the prosecution sought, represents the longest-ever sentence for insider trading.⁹ In addition, the district court judge presiding over the Securities and Exchange Commission (SEC) case ordered Rajaratnam to pay a \$92.8 million penalty, the largest ever imposed in a SEC insider trading case.¹⁰ Combining the penalty with fines and forfeitures imposed at the time of his sentencing, Rajaratnam will pay a total of \$156.6 million.¹¹

The sentencing of Rajaratnam was an important moment in a recent push by federal prosecutors to pursue insider trading prosecutions aggressively. In the two-year period leading up to Rajaratnam's conviction, Preet Bharara, the current U.S. Attorney for the Southern District of New York, brought charges against fifty-four individuals for insider trading crimes.¹² Of those, fifty have been convicted at trial or have pled guilty, while the matters of three others remain pending, and one is a fugitive.¹³

A recent study published by the *Wall Street Journal* indicates that sentences for insider trading have become longer and that those sentenced are more likely to spend time in prison than they had been previously.¹⁴ In the past two years, 79 percent of those sentenced for insider trading violations in New York federal courts have been sent to prison, compared with 59 percent in the 2000s, and less than half of those sentenced from 1993 to 1999.¹⁵ Additionally, in the past two years, the median sentence for defendants sent to prison for insider trading violations has risen to 2.5 years, up from 18 months in the previous decade and 11.5 months from 1993 to 1999.¹⁶

7. See generally Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1625 (1999) (noting that because insider trading is difficult to detect in many instances and the rewards for insider trading are potentially significant, the penalties must be stiff in order to provide an effective deterrent to the conduct).

8. See Susan Pulliam, *Galleon Sinks, Informant Surfaces*, WALL ST. J., Oct. 22, 2009, at A1.

9. Pulliam & Bray, *supra* note 1. Prior to Rajaratnam's sentencing, the longest sentence for insider trading had been imposed on Zvi Goffer, another participant in the Galleon trading scandal. *Id.*

10. See SEC v. Rajaratnam, No. 09 Civ. 8811, 2011 WL 5374112, at *4 (S.D.N.Y. Nov. 8, 2011); Peter Lattman, *Rajaratnam Is Ordered to Pay \$92.8 Million Penalty in Trading Case*, N.Y. TIMES, Nov. 9, 2011, at B3.

11. See Lattman, *supra* note 10.

12. Peter Lattman, *11 Years in Jail for Fund Chief in Stock Deals*, N.Y. TIMES, Oct. 14, 2011, at A1.

13. *Id.*

14. See Chad Bray & Rob Barry, *Long Jail Terms on Rise*, WALL ST. J., Oct. 13, 2011, at C1.

15. See *id.*

16. *Id.*

Despite the high-profile media and prosecutorial attention insider trading cases enjoy, the limits of liability for insider trading and even its doctrinal underpinnings remain uncertain.¹⁷ Individuals such as Rajaratnam are liable under current insider trading law when they receive improper tips from company insiders, even if they are outsiders to the company about which they receive confidential information and in whose securities they trade.¹⁸ On the other hand, it is unclear under current doctrine whether an individual who does not receive a tip, but who steals confidential information from a company to which she is an outsider in order to use the information to make a securities trade, is liable for unlawful insider trading.¹⁹ This is a worrisome gap in securities laws that can be exploited by a number of thieves.²⁰

This Note addresses this important issue. Part I examines the background and development of insider trading liability. It reviews the purpose behind the initial prohibition against insider trading as well as the subsequent evolution of insider and outsider trading doctrine through judicial decisions. Part II examines the impact of the Supreme Court's acceptance of the misappropriation theory in *United States v. O'Hagan*,²¹ which expanded liability for trading on material nonpublic information to outsiders. Finally, Part III argues that holding all thieves liable for trading on stolen material nonpublic information is consistent with Supreme Court case law and constitutes sound public policy.

I. DEVELOPMENT OF THE PROHIBITIONS AGAINST INSIDER AND OUTSIDER TRADING

This section provides a brief summary of the theoretical underpinning of the prohibition against insider trading, a review of the statutes prohibiting the practice, and the cases through which the doctrine developed. Part I.A provides an overview of the statutory provisions and SEC rules that prohibit trading on material nonpublic information. Part I.B discusses the scholarship supporting the prohibition against insider and outsider trading and the arguments that support a free market approach to confidential information. Part I.C concludes with a review of the major cases through which the classical and misappropriation theories of insider trading liability developed.

17. See *infra* Part I.B.

18. See *infra* Part I.C.1.d.

19. See Thomas Lee Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 900–01 (2010).

20. See Kimberly D. Krawiec, *Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing United States v. O'Hagan*, 33 TULSA L.J. 163, 174 (1997) (noting that thieves, industrial spies, and nonfiduciaries may not be liable under Supreme Court precedent). Cyber-theft of financial assets and sensitive information by company insiders and outsiders has become common, and can be difficult to detect and prevent. See SEC, CF DISCLOSURE GUIDANCE: TOPIC NO. 2 (Oct. 13, 2011), <http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm>.

21. 521 U.S. 642 (1997).

A. Statutory Background

The Securities Exchange Act of 1934²² provides the statutory authority for the federal prohibition against insider trading.²³ This section examines Congress's purpose in passing the Act and the two sections of the Act under which insider trading violations are prosecuted.

1. The Underlying Purpose Behind the Securities Exchange Act of 1934

The Act provides the statutory authority for the modern prohibition against insider trading.²⁴ The Act was one of many pieces of legislation passed by Congress in the wake of the stock market crash of 1929 to regulate securities and securities markets in the United States.²⁵ The Act regulates securities, their issuers, buyers, and sellers, as well as the securities marketplace, including exchanges.²⁶

Members of Congress during the New Deal recognized the need to restore public confidence in investment securities, and passed the Act with the intention of giving the SEC broad authority to regulate in the public interest.²⁷ The Act's stated purpose was "to insure the maintenance of fair and honest markets."²⁸ Congress's underlying policy concerns in passing the Act were the protection of investors and the integrity of the market.²⁹ To achieve the broad purposes intended by Congress, the Act "assure[s] that dealing in securities is fair and without undue preferences or

22. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78nn (2006).

23. See STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 23 (2d ed. 2007). Professor Bainbridge notes that prior to the enactment of federal securities laws, state law had governed insider trading cases, and though the federal laws have largely preempted state laws, cases are still occasionally brought under state law, and plaintiffs still sometimes include state laws claims along with federal insider trading claims. See *id.* at 7–8, 15.

24. *Id.* at 23.

25. See Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329, 329–30 (1988). In addition to the Act, after the stock market crash of 1929, Congress also passed the Securities Act of 1933, the Public Utilities Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940 to regulate securities. The purpose of New Deal financial regulations has been described as a project to "[m]ak[e] capitalism live up to its pretensions." MICHAEL E. PARRISH, *SECURITIES REGULATIONS AND THE NEW DEAL* 3 (1970). Congress created the SEC in 1934, granting it the authority to administer regulations related to the securities laws. THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 29 (6th ed. 2009).

26. See HAZEN, *supra* note 25, at 20.

27. See PARRISH, *supra* note 25, at 3, 228; Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 461 (1990) (noting that contemporaries of the Act considered it to fundamentally change the relationship between the public and the market).

28. 15 U.S.C. § 78b (2006).

29. See Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 175 (1998) (citing H.R. REP. NO. 94-229, at 91–92 (1975) (Conf. Rep.)).

advantages among investors.”³⁰ Accordingly, it “addresses virtually all aspects of securities transactions and the securities markets generally.”³¹

Prior to passage of the Act, Congress held hearings to examine stock exchange practices during the period leading up to the stock market crash.³² The Senate authorized the Committee on Banking and Currency to hold hearings on the practice of buying and selling stocks.³³ The testimony drew the Committee’s attention to the practice of insider trading.³⁴ In its report, the Committee identified directors and officers breaching their fiduciary duties to aid their market transactions, as well as large shareholders profiting by accessing and using inside information, as “[a]mong the most vicious practices” uncovered by their investigation.³⁵ As the SEC and the Supreme Court would both later note, “A significant purpose of the Exchange Act was to eliminate the idea that use of inside information for personal advantage was a normal emolument of corporate office.”³⁶

2. Statutory Provisions Prohibiting Insider Trading

a. Section 16(b)

Congress acted to address the issue of insider trading in section 16 of the Act.³⁷ Section 16(b) of the Act permits shareholders to sue officers, directors, or shareholders holding more than 10 percent of the company’s stock to recover any short-swing profits gained by the purchase and sale, or sale and purchase, of any equity security in the company occurring within six months of each other.³⁸ The stated purpose of section 16(b) is to “prevent[] the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer.”³⁹ When reviewing transactions for a violation of 16(b), the majority of courts interpret the transactions so as to maximize shareholders recovery.⁴⁰

30. *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 155 (1976) (quoting H.R. REP. NO. 94-229, at 91).

31. HAZEN, *supra* note 25, at 309.

32. *See* Keller & Gehlmann, *supra* note 25, at 338–39.

33. 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES AND EXCHANGE ACT OF 1934, at Item 21 (J.S. Ellenberger & Ellen P. Mahar eds., 1973).

34. *Id.* at 55.

35. *Id.*

36. *Dirks v. SEC*, 463 U.S. 646, 653 n.10 (1983) (quoting *In re Cady, Roberts & Co.*, 40 SEC 907, 912 n.15 (1961)).

37. 15 U.S.C. § 78p (2006).

38. *Id.* § 78p(a)–(b).

39. *Id.* § 78p(b).

40. *See* BAINBRIDGE, *supra* note 23, at 184 (stating that courts interpret section 16(b) to maximize the recovery by companies); HAZEN, *supra* note 25, at 538–39 (noting that many courts take a “broad view” of what constitutes profit under section 16(b)).

Section 16(b) provides a limited prohibition against insider trading.⁴¹ The benefit of section 16(b) is that it clearly defines the conduct prohibited and the penalty for violation.⁴² However, the statute prohibits only a limited range of conduct by insiders.⁴³ The statute is therefore both over-inclusive and under-inclusive.⁴⁴ It may result in liability for an insider who commits a technical violation of the statute without abusing inside information, while allowing an insider to use confidential information but avoid liability by timing her transactions to skirt the letter of the statute.⁴⁵ Despite these limitations, for thirty years after its passage, federal courts addressed insider trading only through section 16(b).⁴⁶

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

Section 16(b) is no longer the lone provision that prohibits insider trading.⁴⁷ Many insider trading cases are now brought under section 10(b)⁴⁸ of the Act and Rule 10b-5⁴⁹ promulgated thereunder.⁵⁰ Section 10(b) of the Act is a general prohibition against fraud or misrepresentation in securities transactions.⁵¹ Under section 10(b), Congress granted authority to the SEC to promulgate rules “as necessary or appropriate in the public interest or for the protection of investors.”⁵²

In 1942, the SEC promulgated Rule 10b-5 under the rulemaking authority granted to it under section 10(b).⁵³ The Rule was originally enacted to fill a gap created by the Act’s prohibition of fraud in the sale of securities, but not their purchase.⁵⁴ It has since become a principal weapon used to fight securities fraud.⁵⁵ The purpose behind Rule 10b-5 is to protect investors from being deceived into purchasing or selling securities.⁵⁶

41. See HAZEN, *supra* note 25, at 535 (noting that Congress considered section 16(b) to be a “crude . . . objective” method of preventing the use of information in a situation with a great potential for abuse).

42. See BAINBRIDGE, *supra* note 23, at 182–83.

43. See *id.*

44. See *id.*

45. HAZEN, *supra* note 25, at 535–36.

46. See Painter et al., *supra* note 29, at 162.

47. See David M. Brodsky & David J. Kramer, *A Critique of the Misappropriation Theory of Insider Trading*, 20 CARDOZO L. REV. 41, 45 (1998) (noting that “section 10(b) and Rule 10b-5 have become the primary provisions for prosecuting insider trading”).

48. 15 U.S.C. § 78j(b) (2006).

49. 17 C.F.R. § 240.10b-5 (2011).

50. See Brodsky & Kramer, *supra* note 47, at 45.

51. See HAZEN, *supra* note 25, at 442.

52. 15 U.S.C. § 78j(b). The development of insider trading doctrine under section 10(b) is covered in greater detail in Part I.C., *infra*.

53. BAINBRIDGE, *supra* note 23, at 27.

54. See, e.g., Ryan M. Davis, Note, *Trimming the “Judicial Oak”: Rule 10b5-2(b)(1), Confidentiality Agreements, and the Proper Scope of Insider Trading Liability*, 63 VAND. L. REV. 1469, 1473 (2010).

55. *Id.*

56. See HAZEN, *supra* note 25, at 442.

Rule 10b-5 contains three specific provisions related to the purchase or sale of a security. The first provision, 10b-5(a), bans the use of “any device, scheme, or artifice to defraud.”⁵⁷ Section 10b-5(b), the second provision, prohibits material misstatements and omissions.⁵⁸ Finally, the third provision, Section 10b-5(c), proscribes “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.”⁵⁹

These three provisions create a broad and adaptable prohibition against securities fraud consistent with the flexible antifraud provision of section 10(b) of the Act.⁶⁰ Taken together, section 10(b) and Rule 10b-5 are “not intended as a specification of particular acts or practices that constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.”⁶¹

B. Economic Arguments Regarding the Prohibition Against Trading on Material Nonpublic Information

Commentators have disagreed on whether insider trading harms investors, and have debated the desirability of the prohibition against insider trading.⁶² Though the debate is unlikely to result in a significant change in securities regulation, and less likely still to lead to a repeal of the ban on insider trading,⁶³ the lack of scholarly consensus suggests one reason why courts have proceeded cautiously in developing insider trading jurisprudence.⁶⁴

Part I.B.1 reviews the arguments made by scholars who support the prohibition against insider trading in order to address the fundamental question of whether the prohibition serves to make markets more efficient and fairer to traders. Part I.B.2 then considers arguments made by scholars who support a free market approach to insider information. Finally, Part I.B.3 concludes by reviewing a recent argument that regulation of outsider trading, such as trading based on inside information stolen by a corporate outsider, is better justified than the prohibition against trading by insiders.

57. 17 C.F.R. § 240.10b-5(a) (2011).

58. 17 C.F.R. § 240.10b-5(b).

59. 17 C.F.R. § 240.10b-5(c).

60. See BAINBRIDGE, *supra* note 23, at 29–30; HAZEN, *supra* note 25, at 442 (describing Rule 10b-5 as the SEC’s “most encompassing antifraud prohibition”).

61. *In re Cady, Roberts & Co.*, 40 SEC 907, 911 (1961). In keeping with the broad purpose of the Act, courts have interpreted the Act “flexibly rather than with narrow technicality.” *Chiarella v. United States*, 445 U.S. 222, 246–47 (1980) (Blackmun, J., dissenting) (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971); *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)).

62. See *infra* Part I.B.1–2.

63. Bainbridge, *supra* note 7, at 1620 (arguing, in response to the suggestion that federal insider trading law be repealed and regulatory jurisdiction be returned to state common law, that because of the way the law of insider trading has developed it would be “too costly” to make a fundamental change of this kind).

64. See *infra* Part I.C.

1. Arguments Supporting the Insider Trading Prohibition

Scholars have developed a number of arguments in support of the prohibition against insider trading. This section reviews four of these arguments. The first two arguments discuss how insider trading reduces market efficiency.⁶⁵ The third involves the potentially negative effect that insider trading would have on management of publicly traded companies with dispersed shareholders.⁶⁶ The fourth relates to what supporters of the prohibition believe is a weakness in the free market approach.⁶⁷

First, scholars contend that insider trading reduces investor confidence and thereby harms the markets.⁶⁸ Congress's purpose in passing the securities laws was primarily to promote the integrity of the stock markets and the public's confidence in the markets.⁶⁹ This purpose was generally moral and political in nature rather than purely economic; the efficient pricing of securities was only a secondary purpose.⁷⁰

However, an economic argument for the benefit of promoting investor confidence exists as well—namely, that insider trading increases transaction costs.⁷¹ Supporters of the prohibition have argued that “[i]nvestors are reluctant to play in what they perceive to be a rigged game.”⁷² To the extent that investors are willing to invest in markets that they perceive to be rigged, they will demand compensation in the form of discounting the securities at the time of purchase.⁷³ The prohibition against insider trading increases confidence among the investing public, which in turn promotes liquidity and investment and reduces the discounting demanded by investors because of perceived unfairness.⁷⁴

Second, supporters of the prohibition argue that the ban makes markets more efficient because it protects the incentives for market analysts to perform their function.⁷⁵ Permitting insider trading would reduce incentives for market analysts to conduct research because they would not be able to learn all of the information on which trading in the market occurs.⁷⁶ The prohibition against insider trading therefore promotes the efficiency of markets by protecting those who gain their informational

65. See Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 110–12 (1998).

66. See James D. Cox, *Insider Trading and Contracting: A Critical Response to the “Chicago School,”* 1986 DUKE L.J. 628, 655–59.

67. *Id.* at 657–58.

68. See Karmel, *supra* note 65, at 110–12.

69. See *supra* Part I.A.1.

70. See Karmel, *supra* note 65, at 111–12.

71. A.C. Pritchard, *United States v. O’Hagan: Agency Law and Justice Powell’s Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 50 (1998).

72. *Id.* at 49.

73. *Id.* (noting that outsiders will discount shares because they will not be able to determine whether the public share price is accurate, but will know that they will systematically lose out to inside traders).

74. See *id.*

75. See Karmel, *supra* note 65, at 110–12.

76. *Id.*

insights by diligence and whose efforts are integral to the informational efficiency of the stock markets.⁷⁷ One criticism of this market efficiency argument, however, is that it underestimates the chilling effect on research.⁷⁸ By discouraging the use of information that has not been previously disclosed, a ban on insider trading reduces the incentive to create such information.⁷⁹

Third, supporters of the prohibition contend that permitting insider trading by managers is not in the interest of public corporations that have a large number of passive owners, primarily, public shareholders.⁸⁰ Such owners will not expend their own resources to monitor and constrain managerial misbehavior because they can free ride on the efforts of others and gain the same benefits.⁸¹ Under a system that permits insider trading, management would control the information related to insider trading and shareholders would lack an effective way to monitor whether the tradeoff between the benefits and costs of insider trading by management was in their interests.⁸² In a system of such informational asymmetry, shareholders would rationally prefer unqualified openness in their managers' compensation arrangement.⁸³ The prohibition against insider trading stands in for the terms to which shareholders and management would agree should a negotiation be possible.⁸⁴ One supporter of the prohibition has argued that permitting insider trading as a form of compensation would harm shareholders; it would lead managers to select projects that are riskier than shareholders would prefer, because managers would capture a share of any gain while leaving shareholders to bear any loss.⁸⁵

Finally, supporters argue that because the prohibition is the status quo, those who advocate a free market approach carry the burden of persuading that the prohibition should be rescinded.⁸⁶ Critics of the ban have deployed empirical data in support of a free market system with respect to confidential information, or have argued that no data exists to support the prohibition.⁸⁷ Supporters counter that empirical data on the topic is scant,

77. Pritchard, *supra* note 71, at 51.

78. See Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 355 (1988).

79. See *id.*

80. Cox, *supra* note 66, at 655–56.

81. *Id.*

82. *Id.* at 657.

83. *Id.* at 657–58.

84. *Id.* In situations in which enforcement is difficult or the costs of enforcing private property rights are high, the state often deploys its regulatory power as a substitute for granting property rights. See Bainbridge, *supra* note 7, at 1626.

85. See Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 332.

86. See Cox, *supra* note 66, at 657–58.

87. See *id.* at 643–44. But see Henry G. Manne, *Insider Trading: Hayek, Virtual Markets, and the Dog that Did Not Bark*, 31 J. CORP. L. 167, 174–77 (2005) (arguing that, because business people did not complain about insider trading before its prohibition, they

most likely because the topic of insider trading does not lend itself to empirical study, and the conditions to test management in a free market do not exist because of the prohibition.⁸⁸ Thus, supporters insist, the critics' argument that no empirical data supports the prohibition is unpersuasive and does not justify a radical change to the existing regulatory scheme.⁸⁹

2. Arguments in Favor of Permitting Insider Trading

The work of Professor Henry Manne has animated the arguments against the insider trading ban.⁹⁰ Manne questioned the premise of the prohibition, asserting that insider trading did no harm to long-term traders, and criticized the lack of analytical rigor on the part of the ban's supporters.⁹¹ He also advanced two primary arguments in favor of permitting insider trading.

First, Manne argued that insider trading produces the benefit of moving stock prices closer to the price at which the stock would be valued if all information, including inside information, were known to the market.⁹² Inside traders will begin trading on the nonpublic information after gaining access to it. Uninformed traders following the price change of the stock—or who become informed of the confidential information by means of leakage of the information or tipping—will gain insight and trade as well.⁹³ The result of these trades is to move the share price gradually toward the price that incorporates the confidential information, rather than for the share to experience a sharp price change that would be expected to occur upon disclosure of significant confidential information to the trading public.⁹⁴ The pricing rationale articulated by Manne has been criticized as inefficient⁹⁵ and, with respect to the investor who trades with the informed

did not see a problem with the practice and may well have considered it to have beneficial effects).

88. See Cox, *supra* note 66, at 644–45 (noting that because insider trading relies on secrecy, researchers will always lack observable data on which to base their studies).

89. See *id.* at 645.

90. See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966); see also BAINBRIDGE, *supra* note 23, at 133–35.

91. MANNE, *supra* note 90, at 10. Manne has argued that long-term investors, defined as those who trade to rebalance diversified portfolios in changed circumstances or who alter weightings in an already balanced portfolio, would face little harm whereas short-term traders who treat the stock market as a “gambling casino” would frequently lose out as a result of insider trading. See Manne, *supra* note 87, at 169 & nn.7–8.

92. See MANNE, *supra* note 90, at 78–104. Critics of the prohibition against insider trading generally subscribe to the efficient capital markets hypothesis. See Thomas Lee Hazen, *Commentary*, 36 CATH. U. L. REV. 987, 993 (1987).

93. See BAINBRIDGE, *supra* note 23, at 144–45.

94. See MANNE, *supra* note 90, at 80–83, 86–90.

95. See BAINBRIDGE, *supra* note 23, at 144. Movement of prices due to release of information by insider trading has been criticized as slow and, in some instances in which noise trading is sufficiently high, the release of information may fail to move prices at all. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 629–34 (1984).

trader, a poor substitute for disclosure.⁹⁶ Indeed, the type of information likely to move stock prices is often the type that will require prompt disclosure.⁹⁷

Second, Manne argued that permission to use inside information could be a beneficial and appropriate form of compensation for entrepreneurs working at large corporations.⁹⁸ He argued that neither salary nor bonuses were appropriate forms of compensation for an entrepreneur because, while the value of the entrepreneur to the firm is in creating new information, it is rarely possible to value such information in advance.⁹⁹ However, an increase in stock price serves as a reasonably accurate measure of the value of the new information to the firm, and the entrepreneur can recover the invention's value by purchasing the shares in advance of the announcement of the invention.¹⁰⁰

This model has been criticized on a number of grounds. The value recovered by the entrepreneur may not be accurate in that it is limited by the resources with which she can purchase shares.¹⁰¹ Moreover, it is difficult to limit trading only to the entrepreneur and only to situations in which she produces valuable information, rather than bad news that will reduce share price.¹⁰² Finally, it is difficult to design compensation packages properly, given the contingent nature of insider trading.¹⁰³

3. Differential Treatment of Insider and Outsider Trading

Professors Ian Ayres and Stephen Choi advanced a different approach to analyzing trading based on informational advantages.¹⁰⁴ The authors contended that the arguments in favor of banning outsider trading are stronger than the arguments in favor of banning insider trading.¹⁰⁵ This is because the informed outsider fails to internalize the full impact of her trading.¹⁰⁶ The authors agreed with Professor Manne that a firm would be able to “internalize many of the costs and benefits from trades based on inside information on the part of its managers.”¹⁰⁷ By means of a contractual relationship allowing managers to trade on insider information, the firm is able to reduce compensation while providing management with

96. Cox, *supra* note 66, at 646.

97. See WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 692 (3d ed. 2009).

98. See MANNE, *supra* note 90, at 131–45.

99. See *id.* at 134–36.

100. See *id.* at 138–41.

101. See BAINBRIDGE, *supra* note 23, at 146.

102. See *id.* (noting that an inside trader who can profit from a company's loss will be more tolerant of bad news).

103. See *id.* at 147.

104. See generally Ian Ayres & Stephen Choi, *Internalizing Outsider Trading*, 101 MICH. L. REV. 313 (2002).

105. *Id.* at 321.

106. *Id.* at 320.

107. *Id.* at 337–38.

an incentive to maximize profits.¹⁰⁸ Loss to shareholders resulting from managers' insider trading will result in shareholders demanding a discount at the time the company sells its shares to the public.¹⁰⁹ To the extent that managers adjust firm decisions in order to engage in insider trading and these adjustments result in an increased expected cost to shareholders, investors will demand a discount at the time they purchase shares.¹¹⁰ Thus, the authors concluded that a firm that allows insider trading can largely internalize the costs.¹¹¹

In contrast, Ayres and Choi argued that the informed outsider fails to internalize the social impact of trading and therefore should not be permitted to trade on material nonpublic information.¹¹² The outside trader only internalizes the direct cost of obtaining the trading information and the benefits from the use of that information in trading, but ignores the value of increased price accuracy or the costs to the uninformed trader with whom the outside trader conducts the transaction.¹¹³ The authors stated that although "outsider trading without the consent of the traded firm can increase or decrease social welfare. . . . as an empirical matter . . . external costs are likely to be more prevalent than external benefits."¹¹⁴ Ayres and Choi argued that it is difficult for regulators to determine *ex ante* which instances of informed outside trading are socially beneficial and which are detrimental. As a result, the misappropriation theory¹¹⁵ essentially fails in making such a determination because of its blanket prohibition against certain types of outside information advantages.¹¹⁶ They suggested instead that firms are better placed than regulators to make such a determination and should be permitted to do so.¹¹⁷

The misappropriation theory has addressed outsider trading by certain outsiders.¹¹⁸ Ayres and Choi made a strong argument that it would be desirable to expand regulation of outsider trading beyond current limits because of the special concerns that relate to outsider trading.¹¹⁹

4. Summary of Economic Arguments

As described in the brief summary above, the extensive scholarship examining the economic rationale for the prohibition against insider trading

108. *Id.* at 338–39.

109. *Id.* at 340.

110. *Id.*

111. *Id.* at 341.

112. *Id.* at 320.

113. *Id.* at 320–21, 343 (noting that the value of the increase in the accuracy of the price depends on whether and when the information would have become known in the public capital markets without the actions of the outside trader).

114. *Id.* at 343.

115. *See infra* Part II.

116. *See* Ayres & Choi, *supra* note 104, at 354.

117. *See id.* at 354–55.

118. *See infra* Part II.A.

119. *See* Ayres & Choi, *supra* note 104, at 404–08.

has failed to produce a clear consensus either for its prohibition or for changing the regulatory landscape by removing the prohibition. The scholarly commentary also has failed to settle the debate as to whether the prohibition against insider trading succeeds in accomplishing the Act's purpose of ensuring the integrity of markets (or whether a different regulatory scheme, or no scheme at all) would be more effective.¹²⁰ Given the uncertainty of the theory underpinning the prohibition, it is unsurprising that courts have acted carefully in developing the doctrine of the prohibition against insider trading.

C. Evolution of Insider Trading Doctrine via Judicial Decisions

Neither the text of section 10(b) nor the text of Rule 10b-5 mentions insider or outsider trading.¹²¹ As noted above, the scholarly debate surrounding the prohibition against insider and outsider trading has also failed to provide clear support for the theoretical underpinnings of the prohibition. The initial question, therefore, is whether insider or outsider trading constitutes fraud or deceit prohibited under section 10(b) and Rule 10b-5.¹²² In the absence of explicit direction from Congress, and with encouragement from the SEC, courts have developed insider and outsider trading doctrine via judicial decisions.¹²³ Through a series of cases, courts have used the general anti-fraud provisions of section 10(b) and Rule 10b-5 to develop the modern prohibition against insider and outsider trading that extends beyond the limited prohibition described in 16(b).

Courts recognize two theories of liability under section 10(b) and Rule 10b-5 for trading on material nonpublic information. The first is the classical theory of insider trading. The second, not accepted by the

120. See *supra* notes 63–64 and accompanying text.

121. See 15 U.S.C. § 78j(b) (2006); 17 C.F.R. § 240.10b-5 (2011).

122. See Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 576 (2008).

123. Because of the complexity of the jurisprudence and the stiff penalties assigned to those found liable for insider trading, many commentators have encouraged congressional action to provide greater clarity to the prohibition. See, e.g., Hazen, *supra* note 19, at 913–14; Krawiec, *supra* note 20, at 175. Congress has in the past considered legislation to provide a firm definition of insider trading, but in each instance chose not to take action. See Donna M. Nagy, *Insider Trading and the Gradual Demise of Fiduciary Principles*, 94 IOWA L. REV. 1315, 1366–68 (2009) [hereinafter Nagy, *Insider Trading*]. Recently, however, Congress passed legislation to clarify that insider trading by congressional insiders is prohibited. See Robert Pear, *Insider Trading Ban for Lawmakers Clears Congress*, N.Y. TIMES, (Mar. 22, 2012), <http://www.nytimes.com/2012/03/23/us/politics/insider-trading-ban-for-lawmakers-clears-congress.html>. Increased congressional support for the Stop Trading on Congressional Knowledge (STOCK) Act was prompted by an exposé on the television program *60 Minutes*. See Carl Hulse, *A Change in Attitude About Dubious Stock Dealings*, N.Y. TIMES, Nov. 28, 2011, at A17. The STOCK Act was originally proposed in 2006 but found little support, and had been criticized for failing to reach certain behavior. See Donna M. Nagy, *Insider Trading, Congressional Officials, and Duties of Entrustment*, 91 B.U. L. REV. 1105, 1130–37 (2011) (noting that the STOCK Act failed to reach certain hypothetical situations, and failed to deal with obstacles that the SEC would face in investigating members of Congress and staffers).

Supreme Court until 1997, is the misappropriation theory. The remainder of Part I discusses the major cases by which these theories have developed before reviewing two recent enforcement actions by the SEC that test the limits of currently accepted doctrine.

1. Classical Theory

a. *In re Cady, Roberts & Co.*

The classical theory of insider trading liability was first articulated in the SEC proceeding *In re Cady, Roberts & Co.*¹²⁴ During a break in a meeting of the directors of the Curtiss-Wright Corporation, J. Cheever Cowdin, a Curtiss-Wright director, called Robert M. Gintel, one of his partners in the brokerage firm Cady, Roberts & Co., and told him that the board of Curtiss-Wright had decided to approve a dividend cut.¹²⁵ Before the cut was announced publicly, Gintel sold shares from customer accounts, thereby avoiding substantial losses when the Curtiss-Wright share price dropped significantly.¹²⁶

In holding Gintel liable for violating Rule 10b-5, Chairman William Cary articulated the “disclose or abstain” standard of insider trading liability.¹²⁷ An insider of a company must disclose material information known to her by virtue of her position with the company but not known to her trading partner if knowledge of such information would affect the investment decision of the trading partner.¹²⁸ Failure by the insider to disclose the material information in such a situation constitutes fraud.¹²⁹ If disclosure of the material information is not possible or unrealistic under the circumstances, then the insider must abstain from making the transaction.¹³⁰ In *Cady, Roberts*, the board’s decision to reduce the dividend constituted material information and, because of his relationship to Curtiss-Wright as one of its directors, Cowdin was not permitted to trade on that information without disclosure.¹³¹ The prohibition extended to Gintel as well, since he was a partner of Cady, Roberts & Co. with Cowdin.¹³²

b. *SEC v. Texas Gulf Sulphur*

Because *Cady, Roberts* was an SEC administrative decision, and therefore did not constitute binding precedent for the federal courts, there was some question how the courts would treat the duty to disclose or

124. 40 SEC 907 (1961).

125. *Id.* at 909.

126. *Id.* at 909–10.

127. *Id.* at 911.

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.* at 912.

132. *Id.* The case was also one of first impression in that the trades in question occurred over an impersonal exchange rather than face-to-face. *Id.* at 907.

abstain.¹³³ However, the Second Circuit took up the issue of insider trading liability under section 10(b) and Rule 10b-5 several years later, in the case *SEC v. Texas Gulf Sulphur Co.*¹³⁴ On November 12, 1963, a team of employees of Texas Gulf Sulphur Co. (TGS) took geological core samples from a location near Timmons, Ontario that revealed significant copper, zinc, and silver content.¹³⁵ Because of the significance of the initial sample, TGS was convinced of the benefit of acquiring the entirety of the geological segment from which the sample was removed.¹³⁶ To facilitate the acquisition, the president of TGS ordered the members of the team that took the sample to keep the results of the sample confidential, even from other TGS officers, directors, and employees.¹³⁷

In March and April of 1964, TGS engaged in further drilling at the site and confirmed a significant mineralogical discovery.¹³⁸ Meanwhile, the company denied rumors and reports that it had made a major find, going so far as to run a report in general circulation newspapers on April 13, 1964 giving a misleading statement on the find at Timmons.¹³⁹ Shortly thereafter, the company made an official announcement of the find on April 16, 1964, after a journalist who visited the site prepared to publish an article describing a major find at Timmons.¹⁴⁰

During the period between the extraction of the initial sample and the announcement of the find, certain TGS insiders bought TGS shares and options in TGS stock and tipped outsiders as to the significant discovery made at Timmons.¹⁴¹ Two defendants bought TGS shares in the period between the April 13 press report and the official announcement of the discovery on April 16.¹⁴² Also, in February 1964, TGS issued stock options to twenty-six officers and employees, four of whom were aware of the detailed results of the core sample and another of whom was aware of the discovery of a positive sample.¹⁴³ Because of confidentiality concerns, neither the TGS Stock Option Committee nor the Board of Directors had been informed of the discovery, and the insiders with knowledge of the find accepted the options without disclosing their knowledge.¹⁴⁴

On review, the Second Circuit endorsed the disclose or abstain theory, holding that section 10(b) and Rule 10b-5 applied to the insiders' trading activity.¹⁴⁵ The court cited *Cady, Roberts* for the proposition that one who has access to information intended solely for a corporate purpose, and not

133. BAINBRIDGE, *supra* note 23, at 42.

134. 401 F.2d 833 (2d Cir. 1968).

135. *Id.* at 843.

136. *Id.*

137. *Id.*

138. *Id.* at 844.

139. *Id.* at 845–46.

140. *Id.* at 846–47.

141. *Id.* at 844, 847.

142. *Id.* at 847.

143. *Id.* at 844.

144. *Id.*

145. *Id.* at 847–48.

for the personal benefit of anyone, may not use the information if she knows it is unavailable to the person with whom she trades.¹⁴⁶ The Second Circuit noted that the prohibition was not limited to insiders, but that “anyone” in possession of material nonpublic information must “disclose it to the investing public, or, if she is disabled from disclosing it . . . or she chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.”¹⁴⁷ In this case, TGS’s legitimate corporate purpose of maintaining the confidentiality of the find at Timmons did not excuse the insiders’ disclosure requirement; consequently, their trading without disclosure was not permissible.¹⁴⁸

The Second Circuit stated that the disclose or abstain theory “is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information,”¹⁴⁹ known as “parity of information.”¹⁵⁰ In the court’s view, simple possession was sufficient to trigger the disclose or abstain rule, because the requirement extends to “anyone” who has access to information “directly or indirectly.”¹⁵¹

Thus, in *Texas Gulf Sulphur*, the court endorsed a broad theory of insider trading liability based on the disclose or abstain theory, extending it to anyone in possession of material nonpublic information.

c. Chiarella v. United States

When the Supreme Court subsequently addressed insider trading in *Chiarella v. United States*,¹⁵² it did not endorse the same broad liability that the Second Circuit had adopted in *Texas Gulf Sulphur*.¹⁵³ Vincent F. Chiarella was a markup man for Pandick Press, a financial printer that produced announcements of takeover bids.¹⁵⁴ To preserve confidentiality, when Pandick received bid announcements, they contained blanks or false names in the place of the names of the companies involved in the transaction.¹⁵⁵ The real names of the participating companies were not given to Pandick until shortly before the documents were to be printed.¹⁵⁶ Despite this precaution, in five instances Chiarella was able to identify the companies involved in the transactions using other information contained in

146. *Id.* at 848 (citing *In re Cady, Roberts & Co.*, 40 SEC 907, 912 (1961)).

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. 445 U.S. 222 (1980).

153. See BAINBRIDGE, *supra* note 23, at 44 (noting that the insider trading holding of the case, based on the parity of access theory, is no longer good law).

154. *Id.* at 224.

155. *Id.*

156. *Id.*

the redacted documents.¹⁵⁷ And despite company policy and clear warnings against doing so, Chiarella traded on this information, making over \$30,000 in fourteen months.¹⁵⁸ He was convicted at trial of seventeen counts of violating section 10(b) and Rule 10b-5.¹⁵⁹ The Second Circuit affirmed.¹⁶⁰

The Supreme Court reversed Chiarella's convictions.¹⁶¹ Chiarella was convicted under the theory that he had remained silent and willfully failed to inform sellers of the securities he purchased that he had information regarding planned takeover bids that would increase the value of the companies' shares.¹⁶² In reversing, the Court held that one who does not disclose material information prior to engaging in a securities transaction commits fraud only when she has a duty to disclose that information, and a duty to disclose arises only when there is "a fiduciary or other similar relation of trust and confidence" between the two parties.¹⁶³ Because no relationship existed between Chiarella and the sellers that gave rise to a duty to disclose, the Court overturned his conviction.¹⁶⁴

The Court refused to hold that a general duty to forego trading on material nonpublic information exists between all market participants, i.e., that mere possession of material nonpublic information gives rise to a duty to disclose or abstain.¹⁶⁵ The Court thereby rejected the parity of information theory on which the Second Circuit had based its holding in *Texas Gulf Sulphur* and, in doing so, narrowed the scope of liability for insider trading.¹⁶⁶

Chiarella included concurring opinions by Justices John Paul Stevens and William J. Brennan. Justice Stevens's concurrence emphasized that the Court did not reach the live question of whether Chiarella breached a duty of silence owed to his employer and its customers, which would have resulted in an actionable Rule 10b-5 claim.¹⁶⁷ Justice Brennan's concurrence suggested that if the jury had been instructed on section 10(b) liability arising from Chiarella's improperly obtaining and converting nonpublic information used for trading (as opposed to the mere failure to disclose), the result may have been different, but the jury was not instructed that misappropriation was an element of the offense.¹⁶⁸ In Justice Brennan's view, a violation of section 10(b) occurs "whenever [a person] improperly obtains or converts to his own benefit nonpublic information

157. *Id.* at 224, 245.

158. *Id.* at 224.

159. *Id.* at 225.

160. *Id.*

161. *Id.* at 237.

162. *Id.* at 226.

163. *Id.* at 228.

164. *Id.* at 232.

165. *Id.* at 234-35.

166. See Krawiec, *supra* note 20, at 169.

167. *Chiarella*, 445 U.S. at 237-38 (Stevens, J., concurring).

168. *Id.* at 239 (Brennan, J., concurring).

which she then uses in connection with the purchase or sale of securities.”¹⁶⁹

In addition, Chief Justice Warren Burger and Justice Harry Blackmun authored vigorous dissenting opinions. Chief Justice Burger interpreted section 10(b) and Rule 10b-5 to require that “a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.”¹⁷⁰ Under Justice Burger’s reading, the statute and rule do not limit liability to corporate insiders who make deceptive use of corporate information, but apply more broadly to any instance in which an individual accrues informational advantages by unlawful means.¹⁷¹ In his view, Chiarella should have been held liable under section 10(b) and Rule 10b-5 because he stole nonpublic information entrusted to him in confidence, regardless of his relationship to any other party.¹⁷²

Justice Blackmun, joined by Justice Thurgood Marshall, criticized the Court’s imposition of limitations that unduly narrowed the scope of section 10(b).¹⁷³ In Justice Blackmun’s view, the majority did not justify by statutory text or legislative history the requirement that a fiduciary or similar relationship is required to give rise to a duty to disclose or abstain.¹⁷⁴ The purpose of the Act, he asserted, is to ensure fairness in the markets broadly, not to follow the law of fiduciary duty.¹⁷⁵ Justice Blackmun therefore focused on the importance of the insider gaining access to confidential information that an honest investor would not be able to obtain.¹⁷⁶ He would have imposed a prohibition against trading by persons who have access to confidential material information not lawfully available to others.¹⁷⁷

The concurring and dissenting opinions in *Chiarella* indicate dissatisfaction with the limitations of the classical theory as adopted by the Court. The four concurring and dissenting opinions criticized the theory of liability accepted by the majority as unduly narrow, or expressed willingness to consider a broader theory of liability in the event that such an alternative theory was presented to the Court. Nevertheless, in *Chiarella*, the Court affirmed the classical theory of insider trading that locates the prohibition within section 10(b) and Rule 10b-5. Failure to disclose or abstain by one with a duty to speak constitutes fraud, and fraud falls within the statutory and regulatory prohibition.¹⁷⁸

169. *Id.*

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

171. *Id.* at 241–42.

172. *Id.* at 245.

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

174. *Id.* at 246–47.

175. *Id.*

176. *Id.* at 248.

177. *Id.* at 251.

178. Steinbuch, *supra* note 122, at 576.

d. Dirks v. SEC

The next major case in the development of the classical theory of insider trading liability under section 10(b) and Rule 10b-5 was *Dirks v. SEC*.¹⁷⁹ Raymond L. Dirks, an officer of a New York broker-dealer, received confidential information from Ronald Secrist, a former officer of Equity Funding of America (Equity), that the assets of Equity were significantly overstated due to fraudulent practices.¹⁸⁰ Secrist passed the information to Dirks so that Dirks could verify and disclose the fraud.¹⁸¹ Neither Dirks nor his firm owned Equity stock.¹⁸² After satisfying himself that the fraud allegations were true, but before disclosing the fraud, Dirks openly discussed the fraud with a number of clients and investors, some of whom sold their Equity securities.¹⁸³

The question on review by the Supreme Court was whether Dirks could be held liable for insider trading as a “tippee” under section 10(b) and Rule 10b-5. The Court held that a tippee assumes a fiduciary duty to shareholders not to trade on material nonpublic information only when the tipper has breached a fiduciary duty to the shareholders by sharing the information with the tippee, and the tippee knows or should know that the tipper has committed a breach.¹⁸⁴ The tippee’s liability is therefore derivative of the tipper’s.¹⁸⁵ Because the securities laws seek to eliminate the use of material nonpublic information for personal gain, the breach of the duty owed to shareholders occurs when the insider-tipper directly or indirectly profits from the disclosure.¹⁸⁶ Therefore, the Court held that Dirks was not liable because neither Secrist nor the other Equity employees violated a duty to shareholders by profiting from disclosing the fraud to Dirks.¹⁸⁷

As in *Chiarella*, Justice Blackmun authored a dissent, which Justices Brennan and Marshall joined, criticizing the majority for unduly limiting the scope of protection afforded by the securities laws.¹⁸⁸ By creating the subjective limitation on breach by tying it to the insider’s gain, the majority permitted Secrist to disseminate information to Dirks’s clients who sold Equity’s securities, and thereby harm the purchasers to whom Secrist had a duty to disclose.¹⁸⁹ The dissent argued that the improper purpose requirement was without basis in law.¹⁹⁰

179. 463 U.S. 646 (1983).

180. *Id.* at 648–49.

181. *Id.* at 649.

182. *Id.*

183. *Id.*

184. *Id.* at 660.

185. *Id.* at 659.

186. *Id.* at 662–63.

187. *Id.* at 666–67.

188. *Id.* at 667–79 (Blackmun, J., dissenting).

189. *Id.* at 670–71.

190. *Id.* at 676.

Dirks confirmed that when a corporate outsider receives an improper tip from an insider, the outsider might be held liable for insider trading.¹⁹¹ Though liability depends on the breach by the insider, the decision nevertheless represented an important increase in the scope of insider trading liability.¹⁹²

e. Summary of the Classical Theory of Insider Trading

The Court's adoption of the classical theory of insider trading liability under section 10(b) of the Act and Rule 10b-5 holds that an insider commits fraud unless she discloses material nonpublic information on which she trades or abstains from trading.¹⁹³ This duty extends to outsiders who receive tips of material nonpublic information from insiders if the insiders benefit from the disclosure to the tippee.¹⁹⁴ Despite consistent criticism by a minority of the Court, the classical theory does not impose a general duty upon all market participants in possession of information, as originally articulated by Chairman Cary in *Cady, Roberts*, but only upon those with a fiduciary duty to shareholders and their tippees.¹⁹⁵

2. The Misappropriation Theory

The origin of the misappropriation theory is commonly traced to Chief Justice Burger's dissenting opinion in *Chiarella*.¹⁹⁶ At that time, the Court had reserved judgment with respect to misappropriation because the theory was not presented.¹⁹⁷ Nevertheless, in his dissent, Chief Justice Burger had emphasized that a person who misappropriates confidential information has a duty to disclose.¹⁹⁸ Implicit in this view is the notion that liability can extend beyond insiders to a much broader group of outsiders. After *Chiarella*, the SEC worked to persuade the lower courts to accept the misappropriation theory based on the opening in that decision.¹⁹⁹

191. See *supra* notes 183–85 and accompanying text.

192. See BAINBRIDGE, *supra* note 23, at 54–57.

193. See *supra* note 164 and accompanying text.

194. See *supra* notes 185–87 and accompanying text.

195. See *supra* notes 164, 186 and accompanying text.

196. BAINBRIDGE, *supra* note 23, at 99; *supra* notes 170–72 and accompanying text.

197. See *supra* notes 167–68 and accompanying text.

198. See *supra* notes 168–69 and accompanying text.

199. See BAINBRIDGE, *supra* note 23, at 99–100. A circuit split developed with respect to acceptance of the misappropriation theory. The Second, Third, Seventh, and Ninth Circuits accepted the misappropriation theory. See, e.g., SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985); United States v. Newman, 664 F.2d 12 (2d Cir. 1981). The Fourth and Eighth Circuits rejected the theory. See, e.g., United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997); United States v. Bryan, 58 F.3d 933 (4th Cir. 1995).

a. *Carpenter v. United States*

The first Supreme Court case to address the misappropriation theory was *Carpenter v. United States*.²⁰⁰ R. Foster Winans, the author of the popular “*Heard on the Street*” column in the *Wall Street Journal*, breached a duty of confidentiality to his employer by sharing the contents of the column with fellow conspirators before its publication.²⁰¹ Under company policy, the contents of the column were not to be released before publication and, if they were, Winans was to disclose the release to the *Journal*.²⁰² Because the content of the column was known to affect the price of the featured stocks, the conspirators were able to profit by examining the information contained in forthcoming columns and buying or selling stocks in anticipation of the column’s effect.²⁰³

In its decision, the Court emphasized that Winans had deprived the *Journal* of its property right in its confidential business information—namely, the contents and timing of the column.²⁰⁴ Therefore, the *Journal* was the victim of Winans’s fraud, although it neither bought nor sold stocks.²⁰⁵ The scheme satisfied the requirement that it be “in connection with” the purchase or sale of a security because the sole purpose of the scheme was to profit by using the advance information contained in the column.²⁰⁶ Nevertheless, a divided Court affirmed Winans’s conviction 4-4,²⁰⁷ and thus did not create binding precedent.²⁰⁸

b. *United States v. O’Hagan*

The Supreme Court first accepted the misappropriation theory in *United States v. O’Hagan*.²⁰⁹ James O’Hagan was a partner at the law firm Dorsey & Whitney.²¹⁰ O’Hagan learned that his firm had been retained as local counsel to represent Grand Metropolitan in connection with a potential tender offer for Pillsbury’s stock.²¹¹ O’Hagan purchased a number of call

200. 484 U.S. 19 (1987).

201. *Id.* at 23.

202. *Id.*

203. *Id.*

204. *Id.* at 25–26.

205. *Id.* at 24.

206. *Id.*

207. *Id.*

208. A decision by an evenly divided Court serves to affirm the lower court’s decision but does not create precedent. *See Durant v. Essex Co.*, 74 U.S. (7 Wall.) 107, 113 (1868).

209. 521 U.S. 642 (1997).

210. *Id.* at 647. The charges brought against O’Hagan shocked the Minneapolis business community, in which O’Hagan was an “acknowledged star,” responsible for defending important local institutions such as the Mayo Clinic. *See Eben Shapiro, A Leading Lawyer’s Fall Is a Jolt to Minneapolis*, N.Y. TIMES, Jan. 20, 1990, at A33. However, O’Hagan was caught misusing client funds and prosecutors believed that he engaged in the trades at least in part to repay the funds. David Phelps, *High Court to Decide O’Hagan Case*, STAR TRIB., Apr. 14, 1997, at D1.

211. *O’Hagan*, 521 U.S. at 647.

options for Pillsbury stock, and 5,000 shares of Pillsbury common stock, at \$39 per share.²¹² When Grand Metropolitan announced its tender offer, the stock value increased to nearly \$60 per share.²¹³ O'Hagan sold his options and shares, realizing a profit of more than \$4.3 million.²¹⁴

In its decision, the Court adopted the misappropriation theory, holding that O'Hagan's actions satisfied section 10(b)'s requirement of a "deceptive device or contrivance" used "in connection with" the purchase or sale of securities.²¹⁵ Rather than premising liability on a fiduciary relationship between the company insider and shareholders with whom he trades, as in a case of insider trading under the classical theory, the Court premised O'Hagan's liability on his relationship to his firm, which had entrusted him with the confidential information.²¹⁶ The Court stated that O'Hagan owed a "duty of trust and confidence" to his firm and to its client, which he breached by trading on nonpublic information regarding the planned tender offer.²¹⁷

In the Court's view, O'Hagan committed the deception essential to a violation of section 10(b) and Rule 10b-5 when he feigned loyalty to his firm and its client while secretly converting the confidential information for his own gain.²¹⁸ In so doing, O'Hagan defrauded the source of the information.²¹⁹ The Court noted that O'Hagan would not have been liable under the misappropriation theory had he disclosed his intention to trade on the nonpublic information to his firm.²²⁰

The Court determined that O'Hagan's actions also satisfied the requirement that they be "in connection with the purchase or sale of any security."²²¹ The Court held that the fraud was consummated not when the O'Hagan acquired the information, but when he used the information to trade without first making a disclosure to his firm.²²² Because material nonpublic information of the type at issue in *O'Hagan* is "ordinarily" used for the purpose of making securities trades, misappropriation of the information was sufficiently related to the subsequent securities transaction to satisfy section 10(b)'s "in connection with" requirement.²²³

The Court emphasized that the misappropriation theory is consistent with the purpose of the Act to ensure honest markets and promote investor confidence.²²⁴ The Court expressed the view that permitting unchecked use

212. *Id.* at 647–48.

213. *Id.* at 648.

214. *Id.*

215. *Id.* at 653.

216. *Id.* at 652.

217. *Id.* at 653.

218. *Id.* at 653–54.

219. *Id.* at 654–55.

220. *Id.* at 655. The Court noted that even after disclosure, the trader could be liable in some instances under state law for breach of the duty of loyalty. *Id.*

221. *Id.* at 655–56.

222. *Id.*

223. *Id.* at 656–58.

224. *Id.* at 658.

of misappropriated information would permit certain individuals to gain an informational advantage that other parties could not overcome through research, and would cause investors to either refuse to participate in the market, or discount securities.²²⁵

c. SEC v. Zandford

In *SEC v. Zandford*,²²⁶ the Court reversed dismissal of section 10(b) and Rule 10b-5 charges against Charles Zandford, a securities broker who made trades using a client's account and, on twenty-five separate occasions, transferred the proceeds of the trades into his own account.²²⁷ Zandford argued that the securities sales were lawful and the subsequent thefts of the proceeds, though fraudulent, were not "in connection with" the sale.²²⁸ He contended that the theft was analogous to simple theft of cash or securities.²²⁹

The Supreme Court held that Zandford had engaged in a single scheme to defraud his client and each sale of securities was made to further that scheme.²³⁰ In reaching its decision, the Court noted Congress's purpose in passing the Act to ensure honest markets and protect investors, and emphasized the tradition of construing the securities laws flexibly.²³¹ In addition, the Court granted deference to the SEC's broad interpretation of the "in connection with" requirement, which the Court considered reasonable.²³²

3. Recent SEC Enforcement Actions

The Court's acceptance of the misappropriation theory in *O'Hagan* expanded the scope of individuals who could be held liable for violating the prohibition against insider trading. Recently, the SEC has brought actions against investors who misappropriated confidential information but did not stand in any relationship to the source of the information, as *O'Hagan* had to his firm and its client.²³³ The individuals in the cases highlighted below were strangers to the companies about which they gained material nonpublic information and in whose securities they traded; nevertheless, the SEC brought enforcement actions against each of them.²³⁴

225. *Id.* at 658–59.

226. 535 U.S. 813 (2002).

227. *Id.* at 815–16.

228. *Id.* at 820.

229. *Id.*

230. *Id.* at 820–21.

231. *Id.* at 819.

232. *Id.* at 819–20.

233. See Lisa Rachlin, *Recent Developments in the Duty Requirement Under the Misappropriation Theory: A Critique of Cuban's Unintended Consequences*, 11 U.C. DAVIS BUS. L.J. 67, 79–81 (2010).

234. See *id.*

a. SEC v. Stummer

In *SEC v. Stummer*,²³⁵ the SEC charged Michael A. Stummer with insider trading in violation of section 10(b) and Rule 10b-5.²³⁶ Stummer snuck into his brother-in-law's home office, gained access to his computer by guessing his password, then gained access to the network of the private equity firm at which his brother-in-law was employed.²³⁷ He read confidential emails that indicated a planned transaction and then traded using that information.²³⁸

Stummer consented to an entry of judgment without admitting or denying the SEC allegations and agreed to disgorgement of illegal profits and interest, as well as a civil penalty.²³⁹ As a result of the consent agreement, the case was not tried,²⁴⁰ but is nevertheless noteworthy because Stummer bore no fiduciary relationship to his brother-in-law or to the companies involved in the transaction or their shareholders.²⁴¹ Yet the SEC was willing to bring section 10(b) and Rule 10b-5 charges against him and succeeded in obtaining a favorable settlement.²⁴²

b. SEC v. Dorozhko

In *SEC v. Dorozhko*,²⁴³ the SEC brought charges against a computer hacker who accessed confidential information.²⁴⁴ In October 2007, Oleksandr Dorozhko, a resident and national of the Ukraine, opened an online trading account with Interactive Brokers and deposited \$42,500 into the account.²⁴⁵ Also during October 2007, IMS Health, Inc. announced that it would release its third quarter earnings report during a conference call with analysts after the market closed on October 17.²⁴⁶ IMS hired Thomsen Financial, Inc. to provide web-hosting services, including the online release of the earnings report.²⁴⁷ Throughout the day on October 17, a hacker repeatedly attempted to gain access to the IMS earnings report on the Thomsen server, eventually succeeding in locating and downloading the report at 2:15 PM, shortly after it was uploaded to the server.²⁴⁸

235. Litigation Release No. 20,529, SEC, SEC Files Settled Illegal Trading Charges Against Day Trader who Traded on Information He Fraudulently Obtained from His Brother-in-Law (Apr. 17, 2008), <http://www.sec.gov/litigation/litreleases/2008/lr20529.htm>.

236. *See id.*

237. *Id.*

238. *Id.*

239. *See id.*

240. *See id.*

241. *See* Rachlin, *supra* note 233, at 80–81.

242. *See id.*; *see also* Nagy, *Insider Trading*, *supra* note 123, at 1343.

243. 574 F.3d 42 (2d Cir. 2009).

244. *See id.*

245. *Id.* at 44.

246. *Id.*

247. *Id.*

248. *Id.*

Though the IP address of the hacker was known, it had not been traced at the time the SEC sought a preliminary injunction from the U.S. District Court for the Southern District of New York.²⁴⁹ Nevertheless, substantial circumstantial evidence indicated Dorozhko's involvement with the hacking. Shortly after the hacker downloaded the report from the Thomsen server, Dorozhko purchased \$41,670.90 worth of put options using his online trading account.²⁵⁰ Later that afternoon, IMS announced that its quarterly earnings were 28 percent below expectations.²⁵¹ The next morning, IMS shares fell approximately 28 percent almost immediately upon the opening of trading.²⁵² Within minutes of the market opening, Dorozhko sold all his IMS options, realizing a profit of \$286,456.59.²⁵³

After learning about the irregular trading activity from Interactive Brokers, the SEC sought a preliminary injunction in the district court to freeze the proceeds of Dorozhko's sale of his put options.²⁵⁴ The district court denied the motion on the ground that the SEC was unlikely to succeed on the merits of its section 10(b) claim.²⁵⁵ The court rejected the SEC's arguments that the hack was "theft by deception" and therefore "deceptive" within the term's meaning under section 10(b).²⁵⁶ The court reviewed *Chiarella* and *O'Hagan*, and determined that in both cases, liability for insider trading was premised on a fiduciary or similar duty to disclose or abstain.²⁵⁷

On appeal, the Second Circuit vacated the district court's order denying the preliminary injunction.²⁵⁸ In reaching its decision, the court rejected the district court's reading of the relevant Supreme Court precedent that "deceptive" requires the breach of a fiduciary duty in all cases.²⁵⁹ The court engaged in its own reading of *Chiarella*, *O'Hagan*, and *Zandford* and concluded that the cases "all stand for the proposition that nondisclosure in breach of a fiduciary duty satisfies §10(b)'s requirement . . . [of] a deceptive device or contrivance."²⁶⁰ However, the SEC's theory was not that Dorozhko remained silent when he had a duty to disclose or abstain from trading, but rather that he affirmatively misrepresented himself in order to gain access to the nonpublic information he used to make his trades.²⁶¹ The court refused to extend the fiduciary duty requirement to the misappropriation context, writing that "what is sufficient is not always what

249. See *SEC v. Dorozhko*, 606 F. Supp. 2d 321, 326 (S.D.N.Y. 2008), *vacated by SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

250. *Dorozhko*, 574 F.3d at 44.

251. *Id.*

252. *Id.*

253. *Id.*

254. See *Dorozhko*, 606 F. Supp. 2d at 322.

255. See *id.* at 343.

256. *Id.* at 329–30.

257. See *id.* at 330.

258. *Dorozhko*, 574 F.3d at 51.

259. See *id.* at 48.

260. *Id.* at 49.

261. See *id.*

is necessary, and none of the Supreme Court opinions considered by the District Court *require* a fiduciary relationship as an element of an actionable securities claim under Section 10(b).²⁶² The court adopted the interpretation of *Chiarella* and its progeny proposed by the SEC, namely that “misrepresentations are fraudulent, but . . . silence is fraudulent only if there is a duty to disclose.”²⁶³

After distinguishing this case based on the theory of liability, the court then had to determine the definition of “deceptive” that applied in cases where the theory of liability is affirmative misrepresentation. The court held that Dorozhko could be found liable if his conduct was deceptive according to the ordinary meaning of the word.²⁶⁴ The court defined “deceptive” broadly by relying on a dictionary definition rather than choosing a limited definition that would “complicate the enforcement of Section 10(b).”²⁶⁵ The court remanded the case to the district court for determination of whether the hacker gained access to the file by misrepresenting his identity or by exploiting computer code, i.e., whether the hack was deceptive or not.²⁶⁶

II. THE IMPLICATIONS OF THE MISAPPROPRIATION THEORY FOR OUTSIDER TRADING DOCTRINE

The Court’s acceptance of the misappropriation theory in *O’Hagan* marked an important expansion of liability for trading on material nonpublic information to corporate outsiders. Part II reviews the implications of the *O’Hagan* decision and the Court’s acceptance of the misappropriation theory for outsider trading doctrine. Part II.A assesses the impact of the decision in expanding liability to a broader group of outsiders who had not previously been liable under classical insider trading doctrine. Parts II.B and II.C discuss scholarly criticism of the *O’Hagan* decision and address doctrinal tensions resulting from the decision. Next, Part II.D examines how courts and the SEC have treated the fiduciary requirement after *O’Hagan*. Finally, Part II.E asks whether holding persons who steal confidential information and trade using that information liable under section 10(b) and Rule 10b-5 is a justified progression of insider trading doctrine after *O’Hagan*.

262. *See id.*

263. *See id.* at 50.

264. *See id.*

265. *Id.* at 49.

266. *See id.* at 51. Subsequent to the Second Circuit’s decision, the attorney for Dorozhko lost contact with his client. *See Insider Trading: Enforcers Turn Corner on Insider Trading by Hedge Funds, Say Current, Ex-SEC Staff*, Sec. Reg. & L. Rep. (BNA) No. 42, at 519 (Mar. 22, 2010). The SEC subsequently brought a motion for summary judgment, which the attorney for Dorozhko did not oppose. *Id.* The motion was granted by the district court on March 24, 2010. Litigation Release No. 21,465, SEC, SEC Obtains Summary Judgment Against Computer Hacker for Insider Trading (Mar. 29, 2010), <http://www.sec.gov/litigation/litreleases/2010/lr21465.htm>. Because the case was concluded by summary judgment, the district court did not have the opportunity to address the important questions raised by the Second Circuit in its decision.

A. Expansion of Liability to Outsiders

Whether a corporate outsider who did not improperly receive a tip from a corporate insider was forbidden from trading on material nonpublic information had been an open question prior to the *O'Hagan* decision.²⁶⁷ In decisions prior to *O'Hagan*, the Court had only directly addressed the liability of company insiders and those whom they improperly tipped for violating the insider trading prohibition.²⁶⁸ By definition, such individuals were few in number and relatively easy to identify because of their special relationship to the company.²⁶⁹ In the context of insider trading liability, the fiduciary requirement provided a logical, bright-line boundary for defendants who could be liable under section 10(b) and Rule 10b-5.²⁷⁰ Insiders' duty not to trade was understood to be connected with their role in the corporation and their concomitant fiduciary duty.²⁷¹ The prohibition against their trading was plainly consistent with the legislative history of the Act, and with the purpose of preventing insiders from using confidential information for personal gain.²⁷²

In *O'Hagan*, the Court explicitly stated that the misappropriation theory complemented the classical theory, and was intended to target outsiders without a fiduciary duty to shareholders of the company in whose securities they traded.²⁷³ These outsiders represented a group who had not previously faced liability.²⁷⁴ By holding *O'Hagan* liable for violating section 10(b) and Rule 10b-5, the Court confirmed that a broader and more diverse group of corporate outsiders could be held liable for insider trading.²⁷⁵

B. Criticism of *O'Hagan*

O'Hagan presented an easy fact pattern in the sense that *O'Hagan* had a fiduciary duty to his firm as a partner, and violation of a fiduciary duty was an accepted ground for section 10(b) and Rule 10b-5 liability under earlier classical theory insider trading cases.²⁷⁶ As a result, the SEC focused on the fiduciary relationship as the basis of *O'Hagan's* liability.²⁷⁷ Professor Donna Nagy has argued that misappropriation is a broad and flexible doctrine and by considering only the fiduciary theory of liability, the *O'Hagan* decision left unexplored other theories, thereby potentially leaving undefined the full extent of insider trading liability.²⁷⁸

267. See Painter et al., *supra* note 29, at 155.

268. See *supra* Part I.C.1.

269. See Hazen, *supra* note 19, at 890–91.

270. See Nagy, *Insider Trading*, *supra* note 123, at 1335–36.

271. See *supra* notes 163–67 and accompanying text.

272. See Nagy, *Insider Trading*, *supra* note 123, at 1336; *supra* Parts I.A.1, I.C.1.

273. United States v. *O'Hagan*, 521 U.S. 642, 652–53 (1997).

274. See *id.*

275. See *supra* note 217 and accompanying text.

276. See Nagy, *Insider Trading*, *supra* note 123, at 1336.

277. See *id.*

278. See *id.*

The *O'Hagan* decision received criticism on a number of grounds.²⁷⁹ Most relevant to the question of whether thieves can be liable under the misappropriation theory is criticism related to the decision's requirement of a fiduciary duty owed by the misappropriator to the source of the information.²⁸⁰ The Court's description of O'Hagan's duty to his firm was criticized both for failing (1) to articulate clearly the relationship between the fiduciary duty requirement and the harm caused by misappropriation, and (2) to provide clear guidance as to which outsiders could face liability for outsider trading.²⁸¹

1. The *O'Hagan* Decision Did Not Fully Analyze the Fiduciary Relationship

The *O'Hagan* decision has been criticized for its failure to provide a full and satisfactory analysis of the fiduciary duty underlying O'Hagan's liability for misappropriating information from his firm. Scholars have noted that the Court appeared to limit the relationship to a fiduciary one, rather than a relationship of "trust and confidence" used elsewhere, but these scholars have expressed uncertainty with respect to whether the Court intended to establish a new, more limited standard.²⁸² Professor Kimberly Krawiec has noted that although the Court refers repeatedly to a "fiduciary relationship," it failed to define the term.²⁸³ The decision left unclear whether the fiduciary duty that the Court conceived as underpinning the misappropriation theory comes from state or federal law.²⁸⁴ To the extent the Court addressed the characteristics of the fiduciary duty, it merely emphasized the traditional qualities of the duty: trust, loyalty, and confidentiality.²⁸⁵

The *O'Hagan* Court recognized a safe harbor provision for a fiduciary who discloses to the source of the information her intent to trade.²⁸⁶ This provision of the case has been criticized as indicative of the Court's

279. See Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O'Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 867 (2003) (noting that the decision was criticized for "misconstruing the relevant statute; misreading the Supreme Court's own precedents; lacking a coherent doctrinal basis for prohibiting insider trading; leaving too many unanswered questions; creating illogical loopholes in the regulatory scheme; and extending the reach of federal securities laws too far").

280. See Nagy, *Insider Trading*, *supra* note 123, at 1339–40.

281. See Bainbridge, *supra* note 7, at 1634.

282. See Painter et al., *supra* note 29, at 176–77.

283. Krawiec, *supra* note 20, at 174.

284. See Painter et al., *supra* note 29, at 176, 206 (noting that federal courts will have to develop their own common law if the Court intended a federal law of fiduciary duty to apply—and if state law fiduciary principles govern, then different results could occur in different states in instances of similar fact patterns).

285. See Nagy, *Insider Trading*, *supra* note 123, at 1339.

286. *United States v. O'Hagan*, 521 U.S. 642, 655 (1997).

inconsistent application of the fiduciary requirement.²⁸⁷ Such a provision does not make sense as a matter of fiduciary law, but the Court deemed the carve-out necessary because it treated O'Hagan's silence to his firm as the deceptive conduct that brought his actions within section 10(b) of the Act.²⁸⁸

2. The *O'Hagan* Decision Failed to Articulate the Relationship Between the Misappropriation Theory and a Fiduciary Relationship

The Court in *O'Hagan* was clear that it premised O'Hagan's liability on a breach of duty owed to his firm.²⁸⁹ It held O'Hagan liable because he had feigned fidelity to the source of the information, which constituted the deception essential to a finding of liability under the misappropriation theory.²⁹⁰ In requiring the fiduciary relationship, the Court carried over to the misappropriation theory the fiduciary framework that controlled liability under the classical theory.²⁹¹ However, the *O'Hagan* Court failed to articulate why liability under the misappropriation theory should be limited to those who breach a duty to the source of the information, and failed to state why O'Hagan's "feigning fidelity" to his firm was essential to satisfying the deception requirement.²⁹² It is uncertain why the duty to disclose should arise from a fiduciary duty rather than from an obligation to disclose under federal securities law.²⁹³

Requiring a breach of duty between the misappropriator and the source of the information is unrelated to the purpose of the prohibition: to protect investors and the integrity of the market.²⁹⁴ It may be that the Court simply endorsed the government's articulation of the theory, which was consistent with the facts of the case.²⁹⁵ Though O'Hagan's feigned fidelity was deceptive, it is not clear why this should be a prerequisite for an outsider's liability under the misappropriation theory.²⁹⁶

3. Failure to Define Liable Outsiders

After the *Chiarella* decision in 1980, lower courts articulated various conceptions of the misappropriation theory, each with slightly different

287. See Nagy, *Insider Trading*, *supra* note 123, at 1339. The First Circuit treated the safe harbor provision as "arguably dicta." *SEC v. Rocklage*, 470 F.3d 1, 7 (1st Cir. 2006).

288. See Nagy, *Insider Trading*, *supra* note 123, at 1339.

289. *O'Hagan*, 521 U.S. at 653–55.

290. *Id.* at 655.

291. See Nagy, *Insider Trading*, *supra* note 123, at 1336.

292. See *id.*

293. See Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1655–56 (2004).

294. See Krawiec, *supra* note 20, at 174.

295. *O'Hagan*, 521 U.S. at 654, 665 n.6; see Bainbridge, *supra* note 7, at 1638 (noting the repeated approving references in the majority opinion to the government's brief).

296. See Nagy, *Insider Trading*, *supra* note 123, at 1335. For example, the misappropriation theory, as articulated by Chief Justice Burger in his *Chiarella* dissent, is not similarly limited. See *supra* notes 171–72 and accompanying text.

standards, which resulted in vague doctrine.²⁹⁷ Professor Richard Painter and his colleagues noted that the *O'Hagan* Court failed to clarify misappropriation doctrine by providing criteria by which a lower court could distinguish between a fiduciary relationship and a non-fiduciary relationship.²⁹⁸ This vagueness is compounded by the incoherence of requiring a fiduciary relationship between the misappropriator and the source when the purpose is to protect the market and investors.²⁹⁹ Thus, they argued after *O'Hagan* that lower courts will still need to engage in an essentially ad hoc analysis whenever presented with a relationship between the source and the misappropriator that has not been addressed in a previous case.³⁰⁰

The Court's treatment of the fiduciary requirement in *O'Hagan* led some commentators to read the decision as standing for the proposition that the misappropriation theory does not require the breach of a fiduciary duty at all.³⁰¹ The purpose of the misappropriation theory does not require a fiduciary relationship.³⁰² As explained by Justice Blackmun in his *Chiarella* dissent, the misappropriation theory is intended to apply to anyone who misappropriates information and is not necessarily limited to individuals with a fiduciary duty to the source.³⁰³ Thus, reading *O'Hagan* for the proposition that a fiduciary duty is not required for liability—interpreting the decision as a broader prohibition against theft—is consistent with the underlying purpose of the misappropriation theory.

*C. A Fiduciary Requirement Results in the Misappropriation Theory
Being Under-Inclusive*

Critics have posited that limiting liability under the misappropriation theory to cases in which the trader breaches a fiduciary duty to the source of the information is under-inclusive.³⁰⁴ This result occurs because the market and investors are harmed similarly by anyone who trades on material nonpublic information, but only certain outsiders will be liable under the misappropriation theory.³⁰⁵ Likewise, to the extent that a company has a property interest in its confidential business information, as the Court stated in *Carpenter*,³⁰⁶ that company is harmed by a misappropriator using the information to make securities trades regardless of whether the trader was a fiduciary of the company.³⁰⁷

297. See Painter et al., *supra* note 29, at 188.

298. *Id.* at 191.

299. *Id.* at 188.

300. See *id.* at 191.

301. See Steinbuch, *supra* note 122, at 594–96; *Transcript of the Roundtable on Insider Trading: Law, Policy, and Theory After O'Hagan*, 20 CARDOZO L. REV. 7, 27 (1998) (comment of Prof. Marcel Kahan).

302. See *supra* notes 224–25 and accompanying text.

303. *Chiarella v. United States*, 445 U.S. 222, 249 (1980) (Blackmun, J., dissenting).

304. Krawiec, *supra* note 20, at 174.

305. See *id.*

306. See *supra* note 204 and accompanying text.

307. See Davis, *supra* note 54, at 1482.

D. Post-O'Hagan Treatment of the Fiduciary Requirement

In the aftermath of the *O'Hagan* decision, the SEC promulgated Rule 10b5-2.³⁰⁸ Rule 10b5-2 enumerates a non-exhaustive list of circumstances that give rise to a duty of “trust or confidence.”³⁰⁹ The purpose of the rule was to clarify the relationships that could give rise to a duty of trust and confidence.³¹⁰ These circumstances include (1) any time a person agrees to maintain information in confidence,³¹¹ (2) when parties exchange information and a past pattern of sharing confidence exists between the parties such that the recipient knows or should know that the person communicating expects her to maintain the information as confidential,³¹² and (3) when family members exchange information and the receiving party is unable to show that the person sharing the information did not expect that she would keep the information confidential.³¹³

The relationships listed in Rule 10b5-2 have not traditionally been considered fiduciary or fiduciary-like.³¹⁴ An agreement to keep information confidential has not traditionally given rise to a fiduciary duty absent something more.³¹⁵ Thus, under Rule 10b-5, a “duty of trust or confidence” is not synonymous with a fiduciary duty.³¹⁶ One commentator has posited that the promulgation of 10b5-2 confirms that the misappropriation theory is “not about fiduciary relationships at all” but rather “it is about regulating information dissemination in securities markets, and the animating principle is one of equal access.”³¹⁷

Court decisions and SEC enforcement actions in the wake of *O'Hagan* indicate that the question whether a fiduciary duty is required for liability under the misappropriation theory remains open. As described above, the SEC has brought enforcement actions under the misappropriation theory against a hacker who lacked any relationship with the source of the information, and against an individual for accessing his brother-in-law's computer after guessing his password.³¹⁸ In both cases, the SEC targeted individuals who lacked any fiduciary or fiduciary-like duty to the sources of information.³¹⁹

The Second Circuit supported this reading in *Dorozhko* by holding that a fiduciary duty is not always required for a claim under section 10(b) of the

308. 17 C.F.R. § 240.10b5-2 (2011).

309. *Id.*

310. See Joanna B. Apolinsky, *Insider Trading as Misfeasance: The Yielding of the Fiduciary Requirement*, 59 U. KAN. L. REV. 493, 519 (2011).

311. 17 C.F.R. § 240.10b5-2(b)(1).

312. *Id.* § 240.10b5-2(b)(2).

313. *Id.* § 240.10b5-2(b)(3).

314. See Apolinsky, *supra* note 310, at 520.

315. See *id.* at 519–20.

316. See *id.*

317. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1422 (2002).

318. See *supra* Part I.C.3.

319. See *supra* notes 233–34 and accompanying text.

Act.³²⁰ The Second Circuit's holding that Supreme Court precedent does not require a fiduciary duty in all section 10(b) cases is not universally accepted. For example, the district court in *Dorozhko* had held that a fiduciary duty was required.³²¹ Likewise, the Fifth Circuit held in *Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*³²² that a breach of candid disclosure is an essential element of a deceptive device under section 10(b) and Rule 10b-5. A number of scholars have likewise argued that a fiduciary duty is a requirement for any violation of section 10(b) and Rule 10b-5, and have criticized the *Dorozhko* decision for its departure from that requirement.³²³ Nevertheless, the SEC appears, by virtue of its recent enforcement actions, and Rule 10b5-2's promulgation, to be pushing its position that a section 10(b) and Rule 10b-5 violation need not occur only when there is a breach of a fiduciary duty and, at least in *Dorozhko*, the Second Circuit agreed.³²⁴

E. The Duty Not to Steal

Though the debate remains open, if the SEC and Second Circuit are correct, and a fiduciary duty is not a requirement for all section 10(b) and Rule 10b-5 violations, an important limitation on outsider trading liability will be removed. This would, in turn, suggest that the alternative reading of *O'Hagan*—that he violated a duty not to steal confidential information and was liable for violating section 10(b) and Rule 10b-5 regardless of his relationship with his firm—is correct.³²⁵ This reading places emphasis on the acquisition and dissemination of the information into the market.

III. THEFT BY AN OUTSIDER IS SUFFICIENT TO TRIGGER OUTSIDER TRADING LIABILITY

The question remains open whether a theft of information is sufficient to trigger a duty for an outsider to disclose or abstain from trading.³²⁶ Some scholars have read the Supreme Court's decision in *O'Hagan* as not requiring a fiduciary relationship for misappropriation theory liability.³²⁷

320. SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009).

321. SEC v. Dorozhko, 606 F. Supp. 2d 321, 330 (S.D.N.Y. 2008), *vacated by Dorozhko*, 574 F.3d 42.

322. 482 F.3d 372, 389 (5th Cir. 2007).

323. See, e.g., Matthew T.M. Feeks, *Turned Inside-Out: The Development of "Outsider Trading" and How Dorozhko May Expand the Scope of Insider Trading Liability*, 7 J.L. ECON & POL'Y 61, 83–85 (2010); Elizabeth A. Odian, Note, *SEC v. Dorozhko's Affirmative Misrepresentation Theory of Insider Trading: An Improper Means to a Proper End*, 94 MARQ. L. REV. 1313, 1328–29, 1331–33 (2011); Stephen Bainbridge, *The Second Circuit's Egregious Decision in SEC v. Dorozhko*, PROFESSORBAINBRIDGE.COM (July 29, 2009, 4:36 AM), <http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html>.

324. See *Dorozhko*, 574 F.3d at 48; Apolinsky, *supra* note 312, at 521.

325. See *supra* Part II.B.2.

326. See *supra* note 19 and accompanying text.

327. See *supra* note 301 and accompanying text.

Under this reading, the Court articulated a duty not to steal material nonpublic information, rather than a duty not to misappropriate information only in the presence of a fiduciary duty owed by the misappropriator to the source of the information.³²⁸ Until courts have the opportunity to weigh in definitively on a case that presents the issue squarely, or Congress produces clear guidance on the issue, the answer will remain uncertain.

Part III of this Note asserts that all thieves of material nonpublic information should be held liable under the misappropriation theory in light of Supreme Court precedent, recent case law, and public policy consistent with the purpose of the Act. Part III.A reviews Supreme Court precedent related to insider and outsider trading and argues that extension of liability to outsiders is consistent with the Court's treatment of insider and outsider trading doctrine. Part III.B addresses the affirmative misrepresentation theory of outsider trading liability accepted by the Second Circuit in *Dorozhko*, and concludes that the framework is under-inclusive. Part III.C argues that holding all thieves liable for outsider trading is consistent with both the purpose and letter of the Act and with Supreme Court case law. Finally, Part III.D argues the Court should adopt a broader conception of the misappropriation theory, consistent with that articulated by Chief Justice Burger in his *Chiarella* dissent.

A. Extension of Liability to Outsiders

1. Holding Outsiders Liable Is a Natural Extension of Case Law

The history of judicial decisions related to insider and outsider trading liability reveals a clear trend of courts increasing the scope of liability over time.³²⁹ Under *Texas Gulf Sulphur*, all insiders trading on confidential information were liable for insider trading under the parity of information theory.³³⁰ In *Chiarella*, the Supreme Court reduced the scope of liability articulated by the Second Circuit in *Texas Gulf Sulphur* by requiring a fiduciary or similar relationship of trust and confidence to exist between the trading parties to give rise to insider trading liability.³³¹ However, after the step back in *Chiarella*, the Court again expanded liability in *Dirks* by holding that tippees could be held liable for insider trading through the tipper's fiduciary relationship to stockholders, even if the tippee did not have a fiduciary or similar relationship to the stockholders.³³² Finally, in *O'Hagan*, the Court accepted the misappropriation theory, holding that even as an outsider, O'Hagan could be liable for trading on material nonpublic information, though the Court limited liability to outsiders who have a duty to the source of the information.³³³

328. See *supra* Part II.C.

329. See *supra* Part I.C.

330. See *supra* Part I.C.1.b.

331. See *supra* Part I.C.1.c.

332. See *supra* Part I.C.1.d.

333. See *supra* Part I.C.2.b.

The trend of increasing liability for insider and outsider trading indicated in the case history suggests that the courts have not yet defined conclusively the bounds of liability. The Court has proven flexible in its decisions in order to address new behavior as it has been presented. This is in part because of the unclear theoretical underpinnings of insider trading doctrine,³³⁴ but it is also consistent with the tradition of courts interpreting the securities laws flexibly rather than narrowly or technically in order to serve their broad purpose.³³⁵ Should the Court be presented with the question of liability for a thief under the misappropriation theory, the Court's prior decisions are unlikely to limit its expansion of the doctrine.

Holding all thieves liable is a logical extension of existing section 10(b) and Rule 10b-5 doctrine as courts have developed it in the cases above. Through those decisions, the Court has extended liability from insiders, to outsiders who receive tips from insiders, to outsiders who owe a duty to the source of the information. The extension of liability to thieves will require the Court to disclaim a fiduciary duty as a prerequisite in all insider and outsider trading cases, as the Second Circuit held in *Dorozhko*.³³⁶

It is uncertain whether a fiduciary duty is required in all section 10(b) cases.³³⁷ Recent cases, beginning with *O'Hagan*, and SEC enforcement actions indicate that the fiduciary requirement is no longer a prerequisite for outsider trading liability under section 10(b) and Rule 10b-5.³³⁸ The fiduciary requirement had served a sorting function for insider trading cases, separating those with a fiduciary or like relationship who could be held liable for insider trading from those without such a relationship who could not. If scholars are correct, and the misappropriation theory under *O'Hagan* does not require a fiduciary relationship but simply prohibits theft of material nonpublic information, then thieves are liable under the misappropriation theory.

Regardless of the current state of the fiduciary requirement in section 10(b) cases, a strong argument exists that liability for outsider trading should not be premised on a fiduciary duty between the thief and the source of the information. As noted above, scholars criticized *O'Hagan* for premising *O'Hagan's* liability on his fiduciary relationship to the source of the information.³³⁹ Even if *O'Hagan* should be read for the proposition that the misappropriation theory requires the breach of a fiduciary duty to the source of the information in all cases, the Court should do away with the fiduciary requirement because it is unrelated to the harm of theft which the misappropriation theory addresses.

Theft by a fiduciary and theft by a non-fiduciary are both undesirable and worthy of punishment, although for different reasons. Some have argued that a theft by a fiduciary is worse than theft by a non-fiduciary because the

334. *See supra* Part I.B.

335. *See supra* note 61 and accompanying text.

336. *See supra* note 260 and accompanying text.

337. *See supra* Part II.D.

338. *See supra* Parts II.B, II.D.

339. *See supra* Part II.B.2.

fiduciary violates a trust, whereas a non-fiduciary thief does not.³⁴⁰ Other commentators have argued that theft by a non-fiduciary is worse because the non-fiduciary thief both gains and uses information unlawfully, whereas the fiduciary thief gains the information lawfully but then uses it unlawfully.³⁴¹ Companies entrust material nonpublic information to fiduciaries in order to function. The ability of fiduciaries to abuse their position therefore makes strong enforcement desirable. On the other hand, theft by a non-fiduciary can be accomplished easily in many cases and the effects of such thefts can be serious and difficult to detect.³⁴² This suggests that a non-deceptive theft should be punished strongly in order to deter others from engaging in theft of confidential information. The ability of the SEC to obtain treble damages under securities laws has the potential to act as a strong deterrent.³⁴³

2. Limiting Harm from Theft by Outsiders

The purpose of the misappropriation theory, as stated by Justice Blackmun, is to protect against theft and improper use of material nonpublic information, not to deter a specific instance of a fiduciary violation.³⁴⁴ In turn, this goal is consistent with the broad goal of the Act to protect investors and the integrity of the markets.³⁴⁵ Should the Court accept a broader conception of the misappropriation theory that does not rely on a fiduciary relationship, then the goal of the doctrine should be to limit, to the extent possible, the harm to markets, investors, and companies caused by outsiders who steal and trade on material nonpublic information. The purpose of the misappropriation theory and the goal of limiting harm caused by theft can be achieved only incompletely by limiting liability under the misappropriation theory to those who stand in a fiduciary relationship to the source of the information, because most thieves will not be in such a relation to the source of the information. Thus, a broader scope of liability will better achieve the purpose of limiting the harm from theft.

B. The Second Circuit's Deceptive, Non-deceptive Framework

1. Deceptive Thieves Are Liable

The Second Circuit's decision in *Dorozhko* represents an important step toward broadening the scope of section 10(b) and Rule 10b-5 liability to capture a wider range of outsiders and to limit the harm caused by theft.³⁴⁶ The Second Circuit explicitly rejected the necessity of a fiduciary

340. See *SEC v. Cherif*, 933 F.2d 403, 412 (7th Cir. 1991).

341. See Steinbuch, *supra* note 122, at 592.

342. See *supra* note 20 and accompanying text.

343. See *HAZEN*, *supra* note 25, at 507.

344. See *supra* note 175 and accompanying text.

345. See *supra* notes 28–29 and accompanying text.

346. See *supra* Part I.C.3.b.

requirement in all section 10(b) cases.³⁴⁷ By accepting the theory of affirmative misrepresentation in *Dorozhko*, the court appeared to recognize the harm caused by trading on misappropriated material nonpublic information, even when the misappropriator is a thief without a fiduciary relationship to the source of the information.³⁴⁸

2. The Deceptive, Non-deceptive Framework Is Under-Inclusive

Notwithstanding this important step, the deceptive, non-deceptive framework is not a fully satisfactory extension of liability to outsiders. The framework results in liability turning on a technical distinction that will be uncertain in many cases, and fails to sufficiently limit the harm caused by theft of information by outsiders.

a. The Difficulty Distinguishing Deceptive and Non-deceptive Theft

In *Dorozhko*, the Second Circuit extended liability under section 10(b) and Rule 10b-5 for outsider trading to non-fiduciary thieves.³⁴⁹ It did so by holding that a deceptive theft could lead to liability under section 10(b) and Rule 10b-5.³⁵⁰ However, the court remanded the case for determination whether the hack was deceptive because it was accomplished by means of an affirmative misrepresentation, or whether it was “mere theft.”³⁵¹ Although the court’s analysis indicated that deceptive conduct is sufficient for liability under section 10(b), it did not reach the question whether *Dorozhko* would have been liable should the district court have determined that the hack was not deceptive under section 10b and Rule 10b-5.

In practice, distinguishing between deceptive and non-deceptive thefts can be difficult.³⁵² For example, an outsider could commit a deceptive theft by disguising herself in order to gain access to an office and then stealing material nonpublic information from a company once inside. This individual’s conduct is analytically similar to the deceptive hacker who affirmatively misrepresents her identity in order to gain access to a computer system.³⁵³ However, an outsider could also be in a company’s office for a legitimate purpose and steal information while there. Such an individual does not accomplish the theft of information by means of an affirmative misrepresentation. The individual is similar to the non-deceptive hacker who exploits a vulnerability or loophole in computer code to gain access to the company’s computer system and steal information.³⁵⁴ The first individual has engaged in affirmative misrepresentation, whereas

347. See *supra* note 262 and accompanying text.

348. See *supra* note 262 and accompanying text.

349. See *supra* notes 262–63 and accompanying text.

350. See *supra* notes 262–63 and accompanying text.

351. SEC v. *Dorozhko*, 574 F.3d 42, 51 (2d Cir. 2009).

352. See *supra* note 19 and accompanying text.

353. See *supra* notes 264–67 and accompanying text.

354. See *supra* notes 264–67 and accompanying text.

the second has not, as the distinction is made in *Dorozhko*.³⁵⁵ The first is liable under section 10(b) under the Second Circuit's analysis in *Dorozhko*, whereas the second individual is not.³⁵⁶

Though the example above serves to make clear the distinction between deceptive and non-deceptive theft, the facts of *Dorozhko* demonstrate how difficult the distinction can be to make in practice.³⁵⁷ *Dorozhko* turned on a technical distinction, and imposing liability for securities fraud on the distinction is uncertain.

The distinction between deceptive and non-deceptive theft may implicate the steps that the company will take following the theft. For example, a non-deceptive theft such as the exploitation of faulty code by an anonymous hacker may have the positive result of providing an incentive to close such security loopholes. In either case, however, the result is the violation of the company's property right in its confidential information and harm to investors and the market. Therefore, it is desirable that both types of theft be punished.

b. Distinguishing Deceptive and Non-deceptive Theft Is Inconsistent with the Act and Case Law

The broad purposes of the Act are to ensure the integrity of the securities markets and to protect investors.³⁵⁸ The deceptive, non-deceptive framework is problematic not only because the distinction between the two is difficult to make but also because the non-deceptive thief may not be liable; the framework is potentially under-inclusive and therefore fails to advance the purpose of the Act satisfactorily. As indicated in the Second Circuit's decision, a thief may be able to escape liability depending on a technical determination of the manner by which she gained access to the confidential information.³⁵⁹

It is an anomalous result that a thief should be able to shield herself from liability to the SEC or receive a lesser punishment based on the means by which she accomplished her theft. In either case the harm is the same to the thief's trading partners, the market, and the source of the information.³⁶⁰ Having liability turn on the distinction appears to be in conflict with goal of flexible interpretation of securities laws.³⁶¹ Premising liability on a technical consideration is likely to result in unsatisfactory results and future expansion of doctrine, as courts recognize other situations in which it is desirable and consistent with the underlying purpose of the Act to hold a thief liable.

355. See *supra* notes 264–67 and accompanying text.

356. See *supra* note 266 and accompanying text.

357. See *supra* notes 264–66 and accompanying text.

358. See *supra* Part I.A.1.

359. See *supra* note 266 and accompanying text.

360. See Michael D. Wheatley, *Apologia for the Second Circuit's Opinion in SEC v. Dorozhko*, 7 J.L. ECON. & POL'Y 25, 51 (2010).

361. See *supra* note 61 and accompanying text.

C. *Holding Non-deceptive Thieves Liable for Outsider Trading Is Consistent with the Act and Current Case Law*

Policy favors holding all thieves liable for stealing and trading using material nonpublic information. To restrict theft to cases accomplished by means of deception is to engage in line-drawing that results in under-inclusive doctrine. This section argues that holding all thieves liable for outsider trading is consistent with the Act.

As discussed above, trading by corporate outsiders presents different problems and creates greater externalities than insider trading.³⁶² Thus, as Stephens and Choi argued, the case for regulating outsider trading is stronger than the case for regulating insider trading.³⁶³ Given the aggressive stance taken by regulators with respect to insider trading and the potential for greater harm by outsiders, outsider trading is likely under-regulated in comparison with insider trading with respect to the goal of protecting markets and investors.

Permitting the use of stolen information undermines the integrity of the securities markets and investors' confidence. The hypothetical described above³⁶⁴ distinguished between deceptive and non-deceptive thieves, but ultimately it is beneficial to investors, the markets, and the source of the information to hold both individuals liable.

As noted above, theft of information by hackers is a growing concern to regulators.³⁶⁵ The facts of *Dorozhko* demonstrate the harm caused by such thieves who trade on material nonpublic information. By using misappropriated information obtained by hacking the server, Dorozhko was able to trade with unwitting market participants using an unfair advantage.³⁶⁶ A trading partner is harmed similarly in this instance as in the instance of a corporate insider trading using material nonpublic information; in either case, she is trading at an informational disadvantage to the misappropriator. Regardless of the means by which Dorozhko accomplished the theft, it is consistent with the Act to hold him liable.

In *Carpenter*, the Court recognized that a company has a property interest in its confidential business information.³⁶⁷ A thief violates this property right by wrongfully taking possession of the company's confidential information in order to trade. Again, regardless of whether the theft was deceptive or non-deceptive, the harm is similar and it is consistent with the Act to hold the thief liable in either case.

In the absence of the breach of a fiduciary duty owed to the source of the information and in the absence of an affirmative misrepresentation, the actions of a thief nevertheless fit within the existing framework of section 10(b) and Rule 10b-5 liability. Rule 10b5-2 provides "a non-exclusive

362. See *supra* Part I.B.3.

363. See *supra* notes 106–07 and accompanying text.

364. See *supra* notes 354–57 and accompanying text.

365. See *supra* note 20 and accompanying text.

366. See *supra* notes 251–54 and accompanying text.

367. See *supra* note 204 and accompanying text.

definition of circumstances in which a person has a duty of trust or confidence for purposes of the ‘misappropriation’ theory.”³⁶⁸ As noted above, the Rule indicates that the misappropriation theory is not concerned with fiduciary relationships so much as with regulating the flow of information in securities markets.³⁶⁹ Theft of information used for securities trading, regardless of the circumstances by which the theft is accomplished, implicates this concern because the thief gains an unfair informational advantage over her trading partners.

D. Chief Justice Burger’s Dissenting Opinion in Chiarella Provides a Broader Construction of the Misappropriation Theory

The view of the misappropriation theory articulated by Chief Justice Burger in his *Chiarella* dissent provides a model for the broader view of the misappropriation theory that courts should adopt.³⁷⁰ The purpose of the misappropriation theory, as articulated by Chief Justice Burger, is preventing trading on misappropriated information when the misappropriator gains the information by unlawful means, regardless of any relationship with the source.³⁷¹ Under this view, the misappropriation theory imposes a general duty to disclose or abstain on any thief.³⁷² This prohibition fits within the language of section 10(b) and Rule 10b-5, which reach “any person engaged in any fraudulent scheme.”³⁷³ This conception of the misappropriation theory has the practical benefit of capturing thieves who are neither fiduciaries, nor engage in affirmative misrepresentation to accomplish their thefts, and therefore does away with two criteria that serve to make the misappropriation theory under-inclusive.

Chief Justice Burger’s view of the misappropriation theory is broad enough to capture all undesirable conduct, including theft of material nonpublic information, without unduly chilling legitimate research. However, the broader liability will not go so far as to usher in a return of the equal access theory that was rejected in *Chiarella*.³⁷⁴ The duty to disclose or abstain would arise from the unlawful acquisition of the information, not simply the possession of information unknown to the market and other investors. Premising the duty to disclose or abstain on the theft of information would merely prevent thieves from using information that others cannot gain by lawful means.³⁷⁵

368. 17 C.F.R. § 240.10b5-2 (2011).

369. See *supra* note 317 and accompanying text.

370. See *supra* notes 170–72 and accompanying text.

371. See *supra* note 171 and accompanying text.

372. See *supra* note 170 and accompanying text.

373. *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

374. See *supra* notes 165–66 and accompanying text.

375. See *supra* note 176 and accompanying text.

CONCLUSION

Over time, the Court has expanded liability for trading on material nonpublic information from corporate insiders only, to tippees, to outsiders such as O'Hagan, standing in a fiduciary relationship to the source of the confidential information. Holding thieves liable for insider trading is the next logical step in the development of the misappropriation theory of liability under section 10(b). The purpose of section 10(b) of the Act and Rule 10b-5 is to ensure the integrity of the securities markets and fairness to investors. Holding thieves liable, as *Dorozhko* clearly demonstrates, is necessary to achieve that goal, but requiring a fiduciary relationship between the thief and the source of the information is inconsistent with this purpose and results in under-inclusive doctrine. Thus, the Court should adopt Chief Justice Burger's view of the misappropriation theory articulated in his *Chiarella* dissent, under which the duty to disclose or abstain from trading extends to all those who steal confidential information.