ARTICLES

DON'T ASK, JUST TELL: INSIDER TRADING AFTER
UNITED STATES v. O'HAGAN

Richard W. Painter,* Kimberly D. Krawiec,** and
Cynthia A. Williams***

You may use your own outline on this exam. You may also use an
outline that has been entrusted to you by someone else, but you must
tell the other person that you are using her outline on the exam. You
do not need her permission. You may furthermore use outlines that
you steal from other persons before or during the exam, so long as
those outlines were not entrusted to you by anybody.

—Wall Street's "Honor Code" after United States v. O'Hagan

---

* Associate Professor, University of Illinois College of Law; Visiting Associate Pro-
fessor, Cornell Law School 1997-98; B.A. Harvard University, J.D. Yale University. I
am particularly indebted to Professors Stephen Bainbridge and William Painter, who
provided invaluable comments on the amicus brief that authors of the article filed in United States v. O'Hagan.

** Assistant Professor, University of Oregon School of Law; B.A. North Carolina
State University, J.D. Georgetown University Law Center. I would like to thank Prof-
essors Keith Aoki and Paul Mahoney for helpful comments on the amicus brief that
the authors of this article filed in United States v. O'Hagan, and David Cramer for re-
search assistance and valuable insights.

*** Assistant Professor, University of Illinois College of Law; B.A. University of
California at Berkeley, J.D. New York University. I would like to thank Professor
John Coates for his thoughtful comments on the amicus brief that authors of this
article filed in United States v. O'Hagan, and Brian Krob and Nathalie Torres for
their careful research assistance.

INTRODUCTION

SINCE the 1960s, federal courts have uniformly held that Section 10(b) of the Securities Exchange Act of 1934\(^2\) (the “1934 Act”) and Rule 10b-5,\(^3\) promulgated thereunder, prohibit corporate insiders and temporary insiders\(^4\) from trading in a corporation’s stock without first disclosing material, nonpublic information to the shareholders with whom they trade.\(^5\) Until the summer of 1997,  

\(^{3}\) 17 C.F.R. § 240.10b-5 (1997).  
\(^{4}\) A temporary insider is one who becomes a temporary fiduciary of a corporation and its shareholders by virtue of having entered into “a special confidential relationship in the conduct of the business of the enterprise and [having been] given access to information solely for corporate purposes.” Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983). Before such temporary insider status will attach, however, “the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.” Id.  
however, the United States Supreme Court avoided deciding an issue discussed in two of the Court’s earlier opinions but never resolved: when a person who is neither a corporate insider nor a temporary insider is forbidden from trading on material, nonpublic information. The Court purported to decide this issue last summer in United States v. O’Hagan but instead rendered a confusing opinion that left many questions unresolved.

The confusion began not with O’Hagan, but with the Court’s 1980 holding in Chiarella v. United States. In that case, the Court held that corporate insiders have a duty to disclose material, nonpublic information to the shareholders with whom they trade, but corporate outsiders have no such duty. Since Chiarella, Congress has not amended the 1934 Act to specify whether or when it is illegal under the 1934 Act for corporate outsiders to trade while in possession of material, nonpublic information. Nonetheless, some courts, at the urging of the Securities and Exchange Commission (the “Commission” or the “SEC”), have built on Chief Justice Warren Burger’s dissent and Justice John Paul Stevens’s concurrence in Chiarella to develop a theory under which certain corporate outsiders are prohibited from trading on the basis of material, nonpublic information. This theory, known as the “misappropriation

---

9 Id. at 227-35. Chiarella rejected the so called equality of access to information theory (the “equality of access theory”), under which any person in possession of material, nonpublic information would have a duty to disclose the information to the market or abstain from trading. 445 U.S. at 233.
10 The SEC in 1980 did promulgate Rule 14e-3, 17 C.F.R. § 240.14e-3 (1997), barring trading on inside information about tender offers. See infra note 54 and accompanying text. Although the validity of Rule 14e-3 was also at issue in O’Hagan, this Article limits its analysis to the Court’s interpretation of the misappropriation theory under Rule 10b-5 and § 10(b) and does not address that portion of the Court’s opinion upholding the Commission’s authority to promulgate Rule 14e-3.
11 See 445 U.S. at 239-40 (Burger, C.J., dissenting); id. at 237-38 (Stevens, J., concurring). For a discussion of the two opinions, see infra text accompanying notes 47-49.
theory," asserts that corporate outsiders, although they have no duty of disclosure to the shareholders with whom they trade, are in violation of Section 10(b) if they trade on the basis of information that was misappropriated from a third party with whom the outsider stood in a fiduciary relationship. The theory has spawned an extraordinary body of cases as well as an even more extraordinary body of hypotheticals appearing in briefs, treatises, and law review articles exploring the extent and nature of the fiduciary relationship necessary to make a corporate outsider guilty of insider trading.\(^\text{12}\)

Because of our concern with both the logic and predictability of this case law, and our understanding that other civil and criminal penalties can be imposed on most persons who trade on material, nonpublic information,\(^\text{13}\) we filed an amicus brief urging the Supreme Court to affirm the United States Court of Appeals for the Eighth Circuit's holding in \textit{United States v. O'Hagan}\(^\text{14}\) that the misappropriation theory does not comport with the text or purpose of the 1934 Act.\(^\text{15}\) Our brief also suggested that Congress, not the courts, should address any perceived gaps in Section 10(b)'s prohibition.\(^\text{16}\)

The Court, however, chose a different path, and a six-Justice majority upheld the misappropriation theory on the ground that it comports with both the statutory language and purpose of Section 10(b).\(^\text{17}\) Although for the reasons set forth in Part I of this Article we disagree with the Court, our primary focus in this Article is on where the courts, Congress, and the Commission should go from here. We question whether the misappropriation theory will be a workable instrument for enforcing the insider trading laws. We also consider the possibility of the Commission amending its rules or Congress amending Section 10(b) to create a uniform and under-

---

\(^{12}\) See infra text accompanying notes 145-152.

\(^{13}\) Federal mail and wire fraud statutes reach most acts of misappropriation. See, \textit{e.g.}, Carpenter \textit{v. United States}, 484 U.S. 19 (1987) (affirming unanimously mail fraud conviction of \textit{Wall Street Journal} reporter who traded on information prior to its publication in newspaper column).

\(^{14}\) \textit{United States v. O'Hagan}, 92 F.3d 612 (8th Cir. 1996).

\(^{15}\) See Brief of Amici Curiae Law Professors and Counsel in Support of Respondent, \textit{O'Hagan} (No. 96-842), \textit{available in} 1997 WL 143793. The brief was written by the authors of this Article. Portions of this Article are drawn from our work on the brief.

\(^{16}\) Id. at 28-30.

standable rule governing trading while in possession of material, nonpublic information.

Part I of this Article discusses the history of the Supreme Court’s Section 10(b) jurisprudence as it relates to insider trading. Particular attention is given to the Court’s insistence prior to O’Hagan that a “material misrepresentation or material failure to disclose,” not merely a breach of fiduciary duty, must exist to impose liability under Section 10(b).\(^8\) Part I also explores the Court’s abandonment in Chiarella of the notion that insider trading liability is premised on a duty that all traders owe to other market participants to disclose material, nonpublic information or else abstain from trading.\(^9\) Unfortunately, Chiarella also left open the possibility that the requisite duty to disclose need not be between participants in the securities markets. Thus, Chiarella gave rise to a complex jurisprudence that sought to protect one class of persons, investors, by enforcing disclosure duties owed to another class, the principals in fiduciary relationships with persons who trade. Particularly in circumstances where the principals in these fiduciary relationships are not themselves investors, it is difficult to connect convincingly the investor protection purpose of the statute with the misappropriation theory.

Part II discusses the pervasive inconsistencies among lower courts in interpreting the misappropriation theory, and how the O’Hagan decision does little to clarify this ambiguous body of case law. Part II also discusses the many scenarios in which it is not certain when a fiduciary relationship exists and when a fiduciary is barred from using his principal’s information. On examination of these scenarios, it is clear that the misappropriation theory remains exceptionally vague as a standard for criminal liability.

Part III discusses Congress’s failure to define illegal trading on material, nonpublic information in its two amendments to the 1934 Act’s insider trading provisions after Chiarella, enacted in 1984 and 1988 respectively.\(^{20}\) Because Congress has not amended Section 10(b) itself, Congress’s post-1934 view of how the courts should in-


\(^9\) 445 U.S. at 232-33.

interpret the insider trading prohibition in Section 10(b) was not considered by the Court in the O'Hagan decision. If Congress wants to change the way courts apply Section 10(b), Congress will have to amend the statute.

Part IV explores how courts should define the scope of the misappropriation theory. If the misappropriation theory is to become an effective tool for enforcing the Section 10(b) insider trading prohibition, due process will require that appellate courts define the theory's parameters far more clearly than they have done so far. The Supreme Court's inadequate definition of the theory in O'Hagan unfortunately exacerbated this already very difficult task.

Part V considers whether the Commission or Congress should act to replace or supplement the misappropriation theory with a clearer definition of when it is illegal for corporate outsiders to trade while in possession of material, nonpublic information. For example, the Commission could specify which categories of fiduciaries are prohibited from trading on which types of information. Congress could go even further and abandon both the misappropriation theory and Chiarella's restrictive interpretation of Section 10(b) by imposing on all traders a duty to disclose material, nonpublic information. Alternatively, Congress could explicitly do what the courts are implicitly doing through the misappropriation theory and create a federal property right in information for certain persons. In doing so, Congress could, for example, impose

---

21 See Brudney, supra note 5 (advocating an equality of access theory).
22 Professor Jonathan Macey has argued that regulation of insider trading does not promote goals of efficiency, fairness, or market integrity, and rather that "the only conceivable justification for banning insider trading is that such trading involves the theft of valuable corporate property from its rightful owner." Jonathan R. Macey, Insider Trading: Economics, Politics, and Policy 67 (1991). Professor Roberta Karmel, a former SEC Commissioner, disputes Professor Macey's view. See Roberta S. Karmel, The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information is Untenable, 59 Brook. L. Rev. 149 (1993) (book review). She points out the following difficulties with viewing insider trading from a property rights perspective: 1) Property rights arguments ignore the theories and policies of the SEC, which is the primary proponent of insider trading restrictions and views insider trading as "unfair and inequitable" to investors; and 2) Property rights in information have little to do with the overall scheme of securities regulation, particularly the mandatory disclosure provisions of the securities laws, which would be undermined if insider trading were permitted. Id. at 151. Our objective in this Article is not to take sides in this debate. Rather we seek to point out that O'Hagan's misappropriation theory in some contexts has little
uniform restrictions on trading or, following the property rights approach a step further, permit issuers to opt out of insider trading restrictions through agreements with company insiders. This Article does not argue the merits or demerits of any one of these approaches; rather, it argues that regulation of insider trading will be far more coherent and more likely to incorporate serious analysis of the issues raised in the voluminous scholarship on the subject if carried out through the administrative rulemaking process or through legislation rather than through judicial decisions. Our concern is that the Commission’s victory in O’Hagan will suppress the much needed clarification of insider trading laws by encouraging both the Commission and Congress to continue with the approach that they have adhered to for decades—leaving Section 10(b) and Rule 10b-5 alone while the courts continue to develop a common law of insider trading.

to do with the misappropriation of corporate property with which Professor Macey is concerned and has even less to do with the investor protection objectives urged by former Commissioner Karmel and by the SEC itself.

23 One proponent of such a system is Professor Macey:

Because no uniform legal rule concerning insider trading would benefit all firms, individual firms should be able to allocate for themselves the rights to trade on the privileged inside information they legitimately possess. Firms should be able to make any allocation they desire, including one that gives such rights to corporate insiders.

Macey, supra note 22, at 5. The principal argument against this approach is that a “lemons problem” will emerge as firms that want to prohibit insider trading are unable to detect it and end up overcompensating dishonest managers who both trade and take the higher salaries paid for agreeing not to trade. Frank H. Easterbrook, Insider Trading as an Agency Problem, in Principals and Agents: The Structure of Business 81, 89, 94 (John W. Pratt & Richard J. Zeckhauser eds., 1985). Professor Macey responds to Judge Easterbrook’s argument by pointing out that shareholders have an incentive to monitor insider trading by corporate managers and that public monitoring and reporting of insider trading could be implemented without imposing a public prohibition. Macey, supra note 22, at 39.

24 A footnote citing to all of the important scholarship on insider trading would itself be too lengthy to attach to this Article, although a small fraction of the relevant scholarship is cited in footnotes 5 and 22-23, above. Wang & Steinberg, supra note 5, at 13-118, provide a more complete summary and analysis of the relevant scholarship.

25 The publication of a notice of proposed rulemaking and the comment period required under the Administrative Procedure Act would both force the Commission to justify its restrictions on insider trading and allow consideration of the arguments raised by legal scholars and economists. See 5 U.S.C. § 553 (1994).
I. The Supreme Court's Insider Trading Decisions Under Section 10(b)

A. The Court's Interpretation of Section 10(b) Prior to O'Hagan

The Supreme Court has maintained that with respect to "the scope of conduct prohibited by [Section] 10(b), the text of the statute controls" and has therefore "refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute." The text of Section 10(b), however, does not even mention insider trading. Although Congress was concerned about insider trading in 1934, it seems unlikely that it specifically envisioned insider trading as coming within the proscriptions of Section 10(b). Section 16 was,

---

25 Central Bank v. First Interstate Bank, 511 U.S. 164, 173 (1994); accord O'Hagan, 117 S. Ct. at 2207 ("Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)'s prohibition.").

26 Central Bank, 511 U.S. at 173.

27 The text reads as follows:

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

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.


28 See Smolowe v. Delendo Corp., 136 F.2d 231, 235-36 (2d Cir.) (noting in the context of § 16(b) that, while Congress considered trading by corporate insiders on the basis of material, nonpublic information to be one of the most serious market abuses, Congress also felt that due to significant problems of proof, a strict liability rule such as that embodied in § 16(b) was the only effective remedy), cert. denied, 320 U.S. 751 (1943).

Similarly, the Commission, when promulgating Rule 10b-5 in 1942, did not adopt language that explicitly prohibited insider trading. See 7 Fed. Reg. 3804 (1942), reprinted in 3 Fed. Sec. L. Rep. (CCH) ¶22,725, at 16,610 (May 21, 1942). The history of the drafting and adoption of Rule 10b-5, which has been retold by Milton Freeman, also indicates that the provision was directed at various acts of market manipulation by corporate insiders, not at insider trading per se. See Proceedings, Conference on Codification of Federal Securities Laws, 22 Bus. Law. 793, 921-23 (1967) (remains of Milton Freeman) (discussing how Rule 10b-5 was promulgated in response to a Boston corporate executive buying his company's stock while making pessimistic statements about the company's future). See also Milton V. Freeman, Foreword, 61 Fordham L. Rev. S-1, S-4-5 (1993) (arguing that the construction of Rule 10b-5 urged by proponents of the misappropriation theory is inappropriate because the purpose of Rule 10b-5 was investor protection).
in fact, the only original provision of the 1934 Act to address insider trading specifically, which it did by requiring insiders to disgorge their profits from certain trades. Some commentators have argued that Congress initially intended to regulate insider trading through Section 16 alone. Section 10(b) instead was viewed as a catch-all provision that allowed the Commission, under the watchful eye of the federal courts, to prohibit "manipulative or deceptive" conduct as it arose and as law enforcement strategies became available.


31 "The conventional wisdom is that Congress enacted section 9 [prohibiting manipulation of security prices] to deal with manipulation and expressed its concern with insiders' informational advantage by enacting section 16." Michael P. Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. 1, 56-57 (1980). See also Stephen M. Bainbridge, Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition, 52 Wash. & Lee L. Rev. 1189, 1229 (1995) (suggesting that Congress intended to address insider trading in § 16(b), not in § 10(b)).

Courts and commentators have observed that one reason insider trading was not subject to a broader prohibition than the restrictions on short swing sales in § 16(b) was that the 1934 Congress did not envision a way to enforce such a prohibition. See, e.g., Smolowe, 136 F.2d at 235-36 ("It is apparent too, from the language of § 16(b) itself, as well as from the Congressional hearings, that the only remedy which its framers deemed effective for this reform was the imposition of a liability based upon an objective measure of profit."); William H. Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5, 65 Colum. L. Rev. 1361, 1375 (1965) ("It should be remembered that in considering various proposals for Section 16(b), Congress rejected a suggestion that the use of inside information be made unlawful, in view of the problems of proof involved."). The legislative history of the provision tends to bear these observations out, as seen from the following exchange:

Mr. Corcoran: [Y]ou have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing.

Senator Gore: You infer the intent from the fact.

Stock Exchange Practices: Hearings on S. Res. 84 (72d Congress) and S. Res. 56 & S. Res. 97 (73d Congress) Before the Senate Comm. on Banking and Currency, 73d Cong. 6557 (1934) (statement of Thomas Gardiner Corcoran, Counsel to the Reconstruction Finance Corporation).

32 "Of course subsection [(b)] is a catch-all clause to prevent manipulative devices . . . ." Stock Exchange Regulation: Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce, 73d Cong. 115 (1934) (statement of Thomas Gardiner Corcoran, Counsel to the Reconstruction Finance Corporation). See also Chiarella v. United States, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catchall clause to prevent fraudulent practices.") (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)).
For thirty years after the passage of the 1934 Act, federal courts addressed insider trading in open markets only through Section 16(b)'s requirement that insiders disgorge profits from short swing trades. In fact, state fiduciary duty law, not federal law, was the first to hold that corporate insiders' trading on inside information is prohibited. Building on both state case law and federal decisions holding that insiders have a duty to disclose material, nonpublic information in face-to-face transactions, the Commission, beginning

---

33 See Gratz v. Claughton, 187 F.2d 46 (2d Cir.), cert. denied, 341 U.S. 920 (1951); Smolowe, 136 F.2d 231; see also Louis Loss, Securities Regulation 1037-38 (2d ed. 1961) (identifying § 16 as the mechanism through which the 1934 Congress sought to address insider trading).

34 In the 1951 edition of his treatise, for example, Professor Louis Loss noted that the so-called "majority" rule at that time was to hold officers and directors subject to a fiduciary duty to the corporation and its shareholders only in dealings with or on behalf of the corporation. Louis Loss, Securities Regulation 824 (1st ed. 1951). In most jurisdictions, officers and directors of corporations could thus, at least theoretically, trade freely in the stock of their own corporation in an individual capacity without any affirmative disclosure obligation, so long as they did not engage in active misrepresentations or half-truths. Id. Professor Loss also noted, however, that while this rule was still the "majority view," it was gradually giving way to a "minority" view that corporate insiders are subject to a fiduciary duty when dealing with shareholders of their corporation and thus must make full disclosure of all material facts. Id. at 824-26.

Indeed, in Strong v. Repide, 213 U.S. 419 (1909), the Supreme Court held that a controlling stockholder and general manager of a corporation was guilty of fraud in purchasing securities from a minority shareholder without disclosure of the status of ongoing negotiations for an extremely profitable contract with the Philippine government. The special facts of the case, such as the controlling shareholder's insider status and special knowledge, but not fiduciary duty per se, dictated full disclosure by the insider. Id. at 431-32. Although not the same as the "minority" view that held such trading to be a breach of "fiduciary" duty, the "special facts" doctrine articulated by the Supreme Court in Strong was being employed with increasing frequency in the "majority" jurisdictions, making them, in Professor Loss's view, indistinguishable from the minority jurisdictions. Loss, supra, at 825-26 ("In actual results the old 'majority' rule has substantially merged into the 'special circumstances' doctrine, which in turn is scarcely distinguishable from the so-called 'minority' rule.").


The rule is clear. It is unlawful [under Rule 10b-5] for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers.
in 1961, and the federal courts several years later, consistently held that open market trading by corporate insiders in possession of material, nonpublic information is a "deceptive" device in violation of Section 10(b) and Rule 10b-5. Until 1980, many courts and commentators also interpreted Section 10(b) and Rule 10b-5 not only to prohibit insider trading under this "classical theory" but also to require any person in possession of material, nonpublic information, whether that person was a corporate insider or outsider, to disclose that information to the market or to abstain from trading (the "equality of access theory").

The Supreme Court, however, took Section 10(b) jurisprudence down a sharply different path in 1980 by substantially narrowing its

_Speed_, 99 F. Supp. at 828-29. See also Loss, supra note 33, at 1456-66 (providing a contemporaneous discussion of what information needed to be disclosed when trading).


_See SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969)._

As the _O'Hagan_ Court observed in describing this "traditional" or "classical theory" of insider trading liability:

[Section] 10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under § 10(b), we have affirmed, because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation."


For analysis of the early development of the prohibition against trading on the basis of material, nonpublic information under Rule 10b-5 and § 10(b) see Painter, supra note 5, § 5.10, at 233; James Farmer et al., Insider Trading in Stocks, 21 Bus. Law. 1009 (1966); Donald C. Langevoort, Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement, 70 Cal. L. Rev. 1 (1982).

_See, e.g., Texas Gulf Sulphur, 401 F.2d at 848 ("Thus, anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."). The SEC suggested the same conclusion:_

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

_Cady, Roberts_, 40 S.E.C. at 912 (footnote omitted). Professor Brudney described the equality of access theory as based on the "premise of investor expectations regarding the relative accessibility of corporate information to market participants." Brudney, supra note 5, at 354.
interpretation of the statutory language. In *Chiarella v. United States*, an employee of a financial printer retained by a hostile tender offeror was charged with trading in the target corporation's stock on information obtained in the course of his employment. The Second Circuit had upheld Chiarella's conviction under an equality of access theory which imposed a general duty to disclose or abstain from trading on those who regularly receive material, nonpublic information. The Supreme Court reversed, holding that "when an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." The Court explained that such a duty to disclose cannot "arise from petitioner's relationship with the sellers of the target company's securities, for petitioner had no prior dealings with them. He was not their agent, he was not a fiduciary, he was not a person in whom the sellers had placed their trust and confidence."

As an alternative basis on which to impose liability, the government argued that Chiarella had breached his duty to yet another party, his employer's customer, the acquiring corporation. The government contended that Chiarella's misappropriation of confidential information from his employer therefore constituted a fraud against both the acquiring corporation and the investors who sold him securities. A majority of the Court, however, refused to consider this "fraud on the source" argument because liability based on a duty owed to Chiarella's employer or to its customer had not been argued by the government at trial and could not therefore be considered on appeal. While agreeing with the majority that

---

41 United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980). The Supreme Court described the Second Circuit's reasoning as follows: [The Second Circuit's] decision thus rested solely upon its belief that the federal securities laws have "created a system providing equal access to information necessary for reasoned and intelligent investment decisions." The use by anyone of material information not generally available is fraudulent, this theory suggests, because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers.

*Chiarella*, 445 U.S. at 232 (quoting *Chiarella*, 588 F.2d at 1362) (citations omitted).
42 *Chiarella*, 445 U.S. at 235.
43 Id. at 232.
44 Id. at 235.
45 Id. at 235-36.
46 Id. at 236. Commenting on *Chiarella* in a later case, the Court restated that § 10(b) is not violated "unless the trader has an independent duty of disclosure."
this second basis of liability (fraud on the source of the information) could not be considered because it had not been presented to the jury, Justice John Paul Stevens discussed it with some approval in his concurrence and emphasized that the Court specifically left open the possibility that such conduct could be deemed illegal in the future.\footnote{47}

Meanwhile Chief Justice Warren Burger, in his dissenting opinion, argued that he would read Section 10(b) and Rule 10b-5 "to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."\footnote{48} Thus, while the Chief Justice's reasoning also relied on misappropriation from a third party as a triggering mechanism, his theory differed from Justice Stevens's in that it embraced a fiduciary duty to other market participants rather than to the source of the information.\footnote{49}

\footnote{47} "If we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted 'a fraud or a deceit' upon those companies 'in connection with the purchase or sale of any security.'"\footnote{Chiarella, 445 U.S. at 238 (Stevens, J., concurring).} Justice Stevens also noted, however, that because the acquiring companies that had entrusted Chiarella's employer with confidential information were not buyers or sellers of the target company's securities at the time of Chiarella's trades and thus would not be able to recover damages from Chiarella for violating Rule 10b-5, "it could also be argued that no actionable violation of Rule 10b-5 had occurred."\footnote{Id. at 238 (Stevens, J., concurring) (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).} Id. at 240 (Burger, C.J., dissenting).

\footnote{48} Id. at 240-41 (Burger, C.J., dissenting). Justice William Brennan, concurring in the judgment, agreed with the Chief Justice that "a person violates § 10(b) whenever he improperly obtains or converts to his own benefit nonpublic information which he then uses in connection with the purchase or sale of securities" but also agreed with the majority that the issue had not been presented to the jury.\footnote{Id. at 239 (Brennan, J., concurring).} Justice Harry Blackman, joined in a dissenting opinion by Justice Thurgood Marshall, argued in favor of an equality of access theory which would hold that "persons having access to confidential material information that is not legally available to others generally are prohibited by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securi-
In 1983, the Court again addressed insider trading under Section 10(b), in *Dirks v. Securities and Exchange Commission*, a case involving trading by persons receiving information from an insider's tippee:

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, ... was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."

Throughout its discussion of the statute in *Dirks*, the majority of the Court appeared to be steering Section 10(b) jurisprudence toward a focus on the duties that traders and their tippers owe and do not owe to the issuer and to other traders, without mention of the duties to third parties that characterized Justice Stevens's concurrence in *Chiarella*. The language used by the Court in *Dirks* seemingly did not bode well for Justice Stevens's version of the misappropriation theory.

---

* "Id. at 251 (Blackmun, J., dissenting). Five members of the Court (The Chief Justice and Justices Stevens, Brennan, Blackmun, and Marshall) thus expressed some willingness to extend to corporate outsiders liability for trading on the basis of material, nonpublic information.


* "See id. at 663 n.23 ("[A] violation may be found only where there is 'intentional or willful conduct designed to deceive or defraud investors . . .'.") (quoting *Ernst & Ernst v. Hochfelder*). As the majority of the Court had already noted in *Chiarella*, a duty to disclose under § 10(b) arises "from a relationship of trust and confidence between parties to a transaction." *Chiarella*, 445 U.S. at 230.

* "A tippee is thus liable if he "'knew the information was given to him in breach of a duty by a person having a special relationship to the issuer not to disclose the information.'" *Dirks*, 463 U.S. at 661 (quoting *Investors Management Co., 44 S.E.C. 633 (1971)*). Later Justice Powell pointed to the lack of support for the misappropriation theory in discussing *Dirks* and *Chiarella* in the first draft of his dissent from denial of certiorari in *Carpenter v. United States*. Carpenter v. United States (No. 86-422), First Draft of Justice Lewis Powell's Dissent from Denial of Certiorari at 4-5 (circulated Dec. 10, 1986), in Papers of Justice Thurgood Marshall (reproduced from
The Commission quickly reacted to the Chiarella decision by promulgating Rule 14e-3,\textsuperscript{44} prohibiting anyone from trading on the basis of material, nonpublic information about a tender offer when he knows or has reason to know that the information was obtained from either the tender offeror or target. The relationship between the trader and the source of the information is irrelevant to the flat prohibition contained in this rule. Thus, in the tender offer context—the source of much if not most of the information used for insider trading—the Commission used the presumably broader powers given to it under Section 14(e) of the 1934 Act\textsuperscript{55} to apply the equality of access theory for which the Commission had argued unsuccessfully in Chiarella in the context of Section 10(b) and Rule 10b-5.

Outside of the tender offer context, however, the Commission and the courts were left with two alternatives with which to reach

\textsuperscript{44} 17 C.F.R. § 240.14e-3 (1997).

\textsuperscript{55} 15 U.S.C. § 78n(e) (1994). Section 14(e) states in relevant part: “The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.” Id. In contrast to the legislative history of § 10(b), the legislative history of the 1970 amendment to § 14(e), the rulemaking provision, indicates that Congress enacted that provision with the full knowledge and intent that the Commission would use the powers it conferred to curb abuses associated with trading on the basis of material, nonpublic information in connection with tender offers. Additional Consumer Protection in Corporate Takeovers and Increasing the Securities Act Exceptions for Small Businessmen: Hearings on S. 336 & S. 3431 Before the Subcomm. on Sec. of the Senate Comm. on Banking and Currency, 91st Congress 10-12 (1970) [hereinafter Hearings on S. 3431] (statement of Hamer H. Budge, Chairman, SEC). During hearings on the 1970 Amendment, Senator Harrison Williams, the bill's sponsor, asked the Commission's Chairman for "examples of the fraudulent, deceptive, or manipulative practices used in tender offers which the proposed Commission rulemaking powers would prevent." Hearings on S. 3431, supra, at 11. In response, the Chairman submitted a memorandum into the record that specifically identified trading on the basis of material, nonpublic information as one such "problem" that the Commission's proposed rulemaking authority would be used to prevent:

The person who has become aware that a tender bid is to be made, or has reason to believe that such bid will be made, may fail to disclose material facts with respect thereto to persons who sell to him securities for which the tender bid is to be made.

Hearings on S. 3431, supra, at 12. As the Second Circuit noted in United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992), the hypothetical presented by the Commission did "not contain any requirement that the trader breach a fiduciary duty." Id. at 559.
trading by persons other than corporate insiders: 1) Ask Congress to endorse the equality of access theory by enacting a specific prohibition on trading while in possession of material, nonpublic information; or 2) Seek to expand Section 10(b) jurisprudence to include one of the misappropriation theories suggested in Chiarella. The Commission chose the second approach and asked the lower federal courts to adopt the theory articulated by Justice Stevens in Chiarella. In referring to this misappropriation theory with apparent approval in his concurring opinion, Justice Stevens thus set in motion a line of decisions in the lower federal courts that, as discussed in Part II below, is based on distinctions that the courts and the Commission did not consider important to the language or purpose of Section 10(b) prior to 1980.34

The problem for the Commission and other proponents of the misappropriation theory was that the duties discussed thus far by the Court in Chiarella and Dirks—duties to the issuer, its shareholders, and the market as a whole—had little to do with the central inquiry of the misappropriation theory: whether a trader breached a fiduciary duty to someone other than the issuer or its shareholders, someone who may not even have bought or sold the security in question. There was legitimate concern that insufficient protection was afforded to investors by Section 10(b) as interpreted by the Court in Chiarella,35 but there was also little evidence that Section 10(b) was ever intended to regulate relationships formed outside the securities markets and protect newspapers from their

---

34 See supra text accompanying notes 33-39 (discussing how prior to Chiarella the Commission and courts focused on the equality of access theory, not on the fiduciary relationships of corporate outsiders that underlie the misappropriation theory).
35 Whether insider trading actually harms investors has been much disputed. Compare Macey, supra note 22, at 24-28 (arguing that insider trading, if anything, helps public shareholders by raising the price at which they sell or lowering the price at which they buy), and Frank H. Easterbrook, Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information, 1981 Sup. Ct. Rev. 309, 325 (same), with Wang & Steinberg, supra note 5, at 41-117 (arguing that insider trading harms individual investors). See also sources cited supra note 5 (offering a wide variety of views on whether insider trading harms public investors and, if so, why). Regardless of which side is correct in this debate, and regardless of whether a person in possession of nonpublic information should be required to disclose the information to investors before trading, it is difficult to conceptualize how public investors are any worse off simply because the person with whom they trade did not disclose her intent to trade to the source of her information.
columnists,\textsuperscript{58} patients from their psychiatrists,\textsuperscript{59} spouses from each other,\textsuperscript{60} parents from their children,\textsuperscript{61} and state lotteries from their commissioners.\textsuperscript{62} Indeed, until the Court's holding in \textit{Chiarella}, there was little thought given to conditioning liability under Section 10(b) on whether or not a trader or a trader's tipper breached a fiduciary duty to some third party having little or no relationship with the trading transaction.\textsuperscript{63}

The misappropriation theory was not presented to the Supreme Court again until 1987 in \textit{Carpenter v. United States}.\textsuperscript{64} A newspaper reporter and a stockbroker were convicted of engaging in a scheme to trade securities on the basis of material, nonpublic information about the content of future editions of the "Heard on the Street" column of the \textit{Wall Street Journal}.\textsuperscript{65} The Second Circuit agreed with the lower court that by misappropriating prepublishation information gathered in the course of conducting research for the column in violation of a known \textit{Wall Street Journal} policy of confidentiality, defendant Winans's conduct had operated as a fraud and deceit against his employer, the \textit{Wall Street Journal}, in violation of Section 10(b) of the 1934 Act.\textsuperscript{66} Although the \textit{Journal} was neither

\textsuperscript{58} \textit{Carpenter v. United States}, 484 U.S. 19 (1987) (evenly divided Supreme Court allowing to stand a Second Circuit holding in which the misappropriation theory was applied to a newspaper columnist's use of information prior to publication of a column on stock market tips).

\textsuperscript{59} \textit{United States v. Willis}, 737 F. Supp. 269 (S.D.N.Y. 1990) (recognizing liability premised on psychiatrist's misappropriation of information entrusted to him by a patient who was the spouse of a corporate insider).

\textsuperscript{60} \textit{United States v. Chestman}, 947 F.2d 551 (2d Cir. 1991) (en banc) (finding no Rule 10b-5 liability where husband used information entrusted to him by his wife about a pending transaction involving her family's company), cert. denied, 503 U.S. 1004 (1992).

\textsuperscript{61} \textit{United States v. Reed}, 601 F. Supp. 685 (S.D.N.Y.) (recognizing federal securities liability premised on son's misappropriation of information entrusted to him by his father), rev'd on other grounds, 773 F.2d 477 (2d Cir. 1985).

\textsuperscript{62} \textit{United States v. Bryan}, 58 F.3d 933 (4th Cir. 1995) (rejecting the misappropriation theory and refusing to impose liability where lottery commissioner used information about a pending contract with the state lottery commission). For a full discussion of these applications of the misappropriation theory, see discussion infra Part I.A.

\textsuperscript{63} Even former SEC Commissioner Charles Cox acknowledged that the misappropriation theory could be seen as "merely a pretext for enforcing equal opportunity in information." Charles C. Cox & Kevin S. Pegarty, Bases of Insider Trading Law, 49 Ohio St. L.J. 353, 366 (1988).

\textsuperscript{64} \textit{Id.} at 20-24.

\textsuperscript{65} \textit{Id.} at 23-24.
a purchaser nor seller of securities, the lower courts concluded that "the fraud was nevertheless considered to be 'in connection with' a purchase or sale of securities within the meaning of the statute [because] the scheme's sole purpose was to buy and sell securities at a profit based on advance information of the column's contents."\textsuperscript{67}

On appeal to the Supreme Court, Winans argued that Section 10(b) did not impose liability because the alleged victim of the fraud, the \textit{Wall Street Journal}, had no interest in the securities at issue.\textsuperscript{68} Once again, however, the Court left unresolved the validity of the misappropriation theory by splitting four to four on the Section 10(b) convictions, thus allowing the lower court's ruling to stand.\textsuperscript{69} Because the Court issued no written opinion on the misappropriation convictions, it is impossible to discern whether the Justices voting against conviction under the misappropriation theory did so because they rejected the misappropriation theory entirely, or merely because they rejected its application to the particular facts presented in \textit{Carpenter}.\textsuperscript{70}

\textsuperscript{67} Id.
\textsuperscript{68} Id. at 24.
\textsuperscript{69} Id.
\textsuperscript{70} The facts of \textit{Carpenter} were somewhat unusual in that "there was no allegation that the information was not available to the public . . . [T]he source of the information[, the \textit{Wall Street Journal},] neither traded in the securities nor received its information from corporate clients who intended to [trade in those securities]." SEC v. Clark, 915 F.2d 439, 446 (9th Cir. 1990) (citations omitted). Important insight may be gained from correspondence between the Justices about \textit{Carpenter}, found in Justice Marshall's papers. When the Court considered denying certiorari in \textit{Carpenter}, Justice Powell wrote a draft dissent from denial of certiorari, discussing the standards set forth in \textit{Chiarella} and \textit{Dirks} and then stating:

\begin{quote}
Applying these principles to this case, it is difficult to understand how any of the petitioners were guilty of criminal securities fraud. The Court of Appeals found no fiduciary relationship between any of the petitioners and the parties from whom they purchased securities. The only fiduciary duty discussed by the court is petitioner Winans' duty to the \textit{Wall Street Journal}. But our previous decisions establish that the duty of an individual to his employer, alone, is insufficient to support an action under Rule 10b-5. The inquiry under that section must focus on "petitioner's relationship with the sellers of the . . . securities . . . ."
\end{quote}

B. O’Hagan

1. The Holding

In 1997, over seventeen years after the misappropriation theory first appeared in Chiarello, the Court finally decided in O’Hagan that the theory comports with the statutory language and intent of Section 10(b).\(^7\)

James Herman O’Hagan was a partner of Minneapolis’s Dorsey & Whitney, the law firm retained in July of 1988 by Grand Metropolitan PLC (“Grand Met”) as local counsel for a planned tender offer for the stock of Pillsbury Company (“Pillsbury”). Although O’Hagan did not personally represent Grand Met, he learned of the tender offer from another partner of the firm and began purchasing both call options for Pillsbury stock and the stock itself. When he sold his options and stock after Grand Met announced its tender offer for Pillsbury in October of 1988, O’Hagan made a profit of almost four and a half million dollars.\(^8\)

O’Hagan was indicted, convicted, and sentenced to forty-one months in prison on fifty-seven criminal counts, including mail fraud and money laundering as well as securities fraud in violation of Section 10(b) of the 1934 Act and Rule 10b-5 and securities fraud in connection with a tender offer in violation of Section 14(e) of the 1934 Act and Rule 14e-3(a).\(^9\) The Eighth Circuit, in a two to one decision, reversed the Section 10(b) convictions,\(^9\) holding that a conviction under Section 10(b) cannot be based on the misappropriation theory, because that theory encompasses neither “deception” nor a “connection with the purchase or sale of any security,” both of which are required under the statute.\(^7\) The Eighth

---

\(^7\) O’Hagan, 117 S. Ct. at 2210.

\(^8\) Id. at 2205.

\(^9\) Id. O’Hagan was also disbarred and convicted in state court of theft and sentenced to 30 months in prison for embezzling money from client trust accounts that he had sought to replenish with his trading in Pillsbury stock and options. See O’Hagan, 117 S. Ct. at 2205 n.2 and accompanying text (citing State v. O’Hagan, 474 N.W.2d 613 (Minn. Ct. App. 1991); In re O’Hagan, 450 N.W.2d 571 (Minn. 1990)).


\(^7\) Id. at 617.
Circuit thus joined the Fourth Circuit in rejecting the misappropriation theory, which had been adopted by three other circuits. The Eighth Circuit also reversed all of O'Hagan's other convictions, holding that Rule 14e-3(a) exceeds the Commission's rulemaking authority, and that the mail fraud and money laundering convictions failed because they depended on the securities convictions.

The Supreme Court, in a six to three decision, reversed the Eighth Circuit and adopted the misappropriation theory. The Court, in a majority opinion written by Justice Ruth Bader Ginsburg, held that "misappropriators, as the Government describes them, deal in deception" because their conduct "dues or defrauds the principal." The opinion concluded that this deception is in connection with the purchase or sale of a security within the meaning of Section 10(b) because the fraud occurs when the fiduciary buys or sells the securities, not when the confidential information is obtained; hence "[t]he securities transaction and the breach of duty . . . coincide." The Court also held that Rule 14e-3(a) is within the Commission's rulemaking authority under Section 14(e) because the Commission's disclose or abstain rule is reasonably designed to prevent misappropriation of confidential information in the tender offer context and need not require the "specific proof of a breach of fiduciary duty" that is required by Section 10(b). Absent from the Court's opinion, however, is any precise explanation

---

76 United States v. Bryan, 58 F.3d 933, 943-59 (4th Cir. 1995).
78 O'Hagan, 92 F.3d at 627.
79 Id. at 627-28.
80 O'Hagan, 117 S. Ct. 2199.
81 Id. at 2208.
82 Id.
83 Id. at 2209.
84 Id. at 2219.
85 Id. at 2214-19. "As we noted in Schreiber, § 14(e)'s rulemaking authorization gives the Commission 'latitude,' even in the context of a term of art like 'manipulative,' 'to regulate nondeceptive activities as a 'reasonably designed' means of preventing manipulative acts, without suggesting any change in the meaning of the term 'manipulative' itself." Id. at 2217 (citing and quoting Schreiber v. Burlington Northern, 472 U.S. 1, 11 n.11 (1985)).
of how Section 14(e) is different from Section 10(b), other than the Court’s statement in a footnote that “[t]he Commission’s power under [Section] 10(b) is more limited.”

The O’Hagan Court observed that trading on misappropriated information harms investors. Following Justice Stevens’s approach in Chiarella, however, it shaped its interpretation of the misappropriation theory around a duty of disclosure to the trader’s principal only: “Chief Justice Burger, dissenting in Chiarella, advanced a broader reading of § 10(b) and Rule 10b-5; the disclosure obligation, as he envisioned it, ran to those with whom the misappropriator trades. The Government does not propose that we adopt a misappropriation theory of that breadth.” From its more limited reading of the misappropriation theory, the Court con-

---

66 O’Hagan, 117 S. Ct. at 2217 n.18. See also id. at 2207 (“Liability under Rule 10b-5, our precedent indicates, does not extend beyond conduct encompassed by § 10(b)’s prohibition.”) The O’Hagan Court presumably knew that interpreting § 10(b) as broadly as it interpreted § 14(e) would impliedly overrule Chiarella’s holding that § 10(b) does not encompass a duty to disclose or abstain from trading under the equality of access theory. See supra text accompanying notes 42-43.


In sentencing O’Hagan, even the trial court considered O’Hagan’s duty to his law firm and client as secondary to the impact of his trading on investors:

   By the way, and parenthetically, I reject your counsel’s argument and his theory that this is not a typical insider trading case. Certainly Dorsey and Whitney were identified as the victims, but it is obvious when you look at where the dollars came from, and the dollars certainly came, that the victims from a pecuniary standpoint, were those who thought they were putting their options into a fair market when they weren’t playing fair.

Transcript of Sentencing Proceedings at 28, United States v. O’Hagan, Crim. No. 4-92-219, (D. Minn., Oct. 27, 1994) (on file with the Virginia Law Review Association). Thus, even though O’Hagan was found guilty of violating § 10(b) under the misappropriation theory, he was sentenced to prison by a judge who ultimately viewed O’Hagan’s actions under a theory much more akin to the equality of access theory rejected by the Court in Chiarella.

68 O’Hagan, 117 S. Ct. at 2208-09 n.6 (citations omitted) (citing Chiarella v. United States, 445 U.S. 222, 240, 243 n.4 (1980) (Burger, C.J., dissenting) (“[A] person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.”)).

69 In O’Hagan the Court stated:

   The “misappropriation theory” holds that a person commits fraud “in connection with” a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading
cluded that, to avoid liability, a fiduciary need only disclose his trades to the principal in the fiduciary relationship, not to the investors with whom he trades.\footnote{50}

2. The Santa Fe Problem

Before the Court decided \textit{O'Hagan}, the most significant obstacle believed to stand in the way of the misappropriation theory was not the majority opinion in \textit{Chiarella}, but the Court's interpretation of Section 10(b) in \textit{Santa Fe Industries v. Green.}\footnote{51} In \textit{Santa Fe}, the minority shareholders of Kirby Lumber Corporation brought an action under Section 10(b) alleging that Kirby's stock had been grossly undervalued in a freeze-out merger of Kirby into Santa Fe, its parent corporation.\footnote{52} The plaintiff shareholders also alleged that there was no business purpose for the merger.\footnote{53} Although the Second Circuit held that Section 10(b) encompassed breach of fiduciary duty,\footnote{54} the Supreme Court reversed, holding that the terms "manipulative" and "deceptive" in the statute require that there be a misrepresentation or omission of a material fact, not merely a breach of fiduciary duty, for there to be a violation.\footnote{55} Arguably,

\begin{flushright}
\footnotesize
pursposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. Id. at 2207 (citations omitted).
\end{flushright}

\footnote{50} "If the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation." Id. at 2209.

\footnote{51} "The misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information." Id. at 2207. By using the phrase "on the basis of nonpublic information" instead of "while in possession of material, nonpublic information," the Court also chose to limit the misappropriation theory's reach to situations where the information was actually "used" for trading purposes. For a prior discussion of this distinction, see Stephen M. Bainbridge, Insider Trading Under the Restatement of the Law Governing Lawyers, 19 J. Corp. L. 1, 2 n.2 (1993).

\footnote{52} 430 U.S. 462 (1977). The difficulty of reconciling the misappropriation theory with the Court's holding in \textit{Santa Fe} has been discussed extensively by Professor Bainbridge. See Bainbridge, supra note 31, at 1257-66.

\footnote{53} \textit{Santa Fe}, 430 U.S. at 465-67.

\footnote{54} Id. at 463.


\footnote{56} \textit{Santa Fe}, 430 U.S. at 476 ("But the cases do not support the proposition . . . that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the Rule.").
O'Hagan's misappropriation theory contradicts the interpretation of Section 10(b) underlying the Court's holding in Santa Fe on three separate grounds: 1) Breach of fiduciary duty, not deception, lies at the heart of the theory; 2) The "deception" required to implicate the theory is entirely different from the "deception" described in Santa Fe; and 3) Misappropriation under the theory has nothing to do with the securities transaction, and thus the "deception" required by Santa Fe, to the extent it exists at all, is not "in connection with" the purchase or sale of a security.

a. O'Hagan's Fiduciary Duty Requirement

Fiduciary duty lies at the core of liability under the misappropriation theory. The critical determination in each case is whether a fiduciary relationship exists creating a duty to disclose to the principal the fiduciary's use of information.\textsuperscript{96} At the very least, this inquiry is tangential to the fundamental policy concerns of Congress in enacting the 1934 Act: investor protection and the integrity of the market.\textsuperscript{97} Arguably, this inquiry also ignores the boundaries established in Santa Fe by introducing agency, fiduciary, and other law into the heart of federal insider trading regulation and embroiling federal courts in precisely the federalization of state law that Santa Fe cautioned against:

Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities . . . .\textsuperscript{98}

\textsuperscript{96} See O'Hagan, 117 S. Ct. at 2207.

\textsuperscript{97} As Congress observed in 1975:

The basic goals of the Exchange Act remain salutary and unchallenged: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are open and orderly.


\textsuperscript{98} Santa Fe, 430 U.S. at 479 (footnote omitted).
Although *Santa Fe* specifically addressed only the Court's reluctance to merge state corporation law into federal securities law,\(^9\) the Court's reasoning applies to federalization of other state law fiduciary duty standards as well, for example, the relationship between lawyers and their clients. Nonetheless, the *O'Hagan* Court simply ignored these concerns. Nowhere in the opinion is this seemingly serious obstacle to the misappropriation theory even discussed.

In addition, in applying the misappropriation theory, courts will either have to inquire into state fiduciary law, or develop their own federal fiduciary law, to determine when a fiduciary relationship exists and what the duties attendant to that relationship are. Although the *O'Hagan* Court appeared to limit the scope of that inquiry by using "fiduciary" to describe the requisite relationship, rather than the amorphous "relationship of trust and confidence" used in some earlier opinions,\(^{100}\) it is unclear whether the Court in fact intended to limit the applicable standard.\(^{101}\) If the Court did articulate a new test in *O'Hagan*, the decision calls into question the way in which those lower court cases applied the misappropriation

---

\(^9\)Some corporate and securities law scholars, including former SEC Chairman William Cary, were suggesting around the time of the *Santa Fe* decision that corporate law be federalized by statute. See William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663, 705 (1974) ("In summary, as long as we operate within a capitalist society and as long as confidence in management is prerequisite to its continuance, there should be a federal interest in the proper conduct of the corporation itself as much as in the market for its securities.").


\(^{101}\) One commentator has distinguished "fiduciary" from "confidential" relationships by arguing that the former arise from a legal mandate attached to certain positions, while the latter arise from specific conduct and expectations between two parties. See George Gleason Bogert, Confidential Relations and Unenforceable Express Trusts, 13 Cornell L.Q. 237, 248 (1928). Under this approach, the relationship between senior corporate officials and their shareholders will always be a fiduciary one, whereas the relationship between a husband and wife may or may not be confidential, depending on the specific relationship and expectations between two parties. Black's Law Dictionary, however, defines a "confidential relation" as a "fiduciary relation." Black's Law Dictionary 298 (6th ed. 1990). Nonetheless, courts interpreting the misappropriation theory appear to draw a distinction between the two terms. See infra note 103.
theory using the "trust and confidence" standard. Specifically, the situation in which information has been misappropriated from one whose relationship with the trader is familial, rather than fiduciary in the traditional sense, may no longer fall within the proscriptions of Section 10(b) as defined by the O'Hagan Court.

Furthermore, O'Hagan does not provide any guidance as to what distinguishes a fiduciary relationship from other types of relationships. A lawyer, for example, is clearly a fiduciary for a client, as is an accountant or a financial printer entrusted with confidential information. O'Hagan, however, leaves unclear whether many other persons who have access to confidential information would also be fiduciaries under its version of the misappropriation theory, such as a close friend entrusted with family secrets, a barber, a taxi driver, a waiter, or a computer repair person.

102 See cases cited supra note 100 and accompanying text.

103 The relationships traditionally considered to be fiduciary in nature include: attorney and client, executor and heir, guardian and ward, principal and agent, trustee and trust beneficiary, partner and partner, and corporate officer or director and shareholder. See, e.g., John C. Coffee, Jr., From Tort to Crime: Some Reflections on the Criminalization of Fiduciary Breaches and the Problematic Line Between Law and Ethics, 19 Am. Crim. L. Rev. 117, 150 (1981); Austin W. Scott, The Fiduciary Principle, 37 Cal. L. Rev. 539, 541 (1949). Although this list is plainly not exclusive and many other types of relationships can be fiduciary in nature, including relationships of kinship or marriage, the trend among courts interpreting the misappropriation theory appears to be that, while familial relationships may sometimes be confidential, they are not fiduciary. See, e.g., Chestman, 947 F.2d at 568 (finding marriage to be not inherently fiduciary, then considering whether such relationship was one of "trust and confidence"); Reed, 601 F. Supp. at 704-05 (conceding that relationship between father and son is not inherently fiduciary, but finding that it was arguably, in that instance, confidential).

104 Maksym v. Loesch, 937 F.2d 1237, 1241 (7th Cir. 1991) ("What is true is that a lawyer is a fiduciary of his client and that a fiduciary is presumptively barred from self-dealing at the expense of the person to whom he stands in a fiduciary relationship.").


106 A financial printer, like any other agent is a "fiduciary with respect to matters within the scope of [its] agency," Restatement (Second) of Agency § 13 (1958). "The law requires the utmost good faith from agents. The relation is one of trust and confidence, and an agent will not be permitted to make profit for himself in the transaction of the business of his principal." United States v. Starr, 816 F.2d 94, 104 (2d Cir. 1987) (Van Graafeiland, J., dissenting) (quoting Noyes v. Landon, 10 A. 342, 345 (Vt. 1887)).
b. Santa Fe’s Requirement of Deception

The Santa Fe Court held that there must be a “material misrepresentation or material failure to disclose,” for conduct to be “deceptive” as that term is used in Section 10(b).107 In Chiarella, the Court agreed, rejecting the view that mere possession of material, nonpublic information, without more, gives rise to a duty to disclose and, thus, absent disclosure, to deception.108 In O’Hagan, however, the Court appeared less concerned with this deception requirement in Section 10(b). Although O’Hagan had appropriated information belonging to one of his firm’s clients for his own use,109 there is no obvious reason why this is any more a deception for purposes of Section 10(b) than any other conversion of property—for example, if O’Hagan had used his telephone at work to call his broker long distance without reimbursing his employer. The misappropriation theory thus arguably does not comport with Santa Fe’s holding that a claim “states a cause of action under any part of Rule 10b-5 only if the conduct alleged can be fairly viewed as ‘manipulative or deceptive’ within the meaning of the statute.”110

The O’Hagan Court confronted this objection by emphasizing that once a fiduciary duty and breach of that duty are found, it is the failure to disclose the breach to the principal, not the breach itself, that creates liability under Section 10(b). The Court stated:

The misappropriation theory advanced by the Government is consistent with Santa Fe Industries, Inc. v. Green, a decision underscoring that § 10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception. In contrast to the Government’s allegations in

---

107 430 U.S. at 474. As pointed out by the Fourth Circuit in United States v. Bryan, 58 F.3d 933 (4th Cir. 1995), the misappropriation theory also puts the materiality requirement under section 10(b) entirely out of context. Id. at 949 n.16. Materiality for purposes of § 10(b), and indeed the securities laws generally, is judged from the perspective of a reasonable investor. See TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (“[For purposes of § 14(a) proxy disclosures, a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.”); Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (applying the TSC materiality standard for purposes of § 10(b)). In circumstances where the trader’s entrusted is not an investor, it is difficult to understand how these definitions of materiality can be relevant to the inquiry.
110 Santa Fe, 430 U.S. at 473-74.
In this case, in *Santa Fe Industries*, all pertinent facts were disclosed by the persons charged with violating § 10(b) and Rule 10b-5; therefore, there was no deception through nondisclosure to which liability under those provisions could attach.\footnote{111}

Under the *O'Hagan* Court's approach, the trading itself does not trigger Section 10(b) liability. Neither does failure to disclose the information to the public or to other market participants. Rather, it is the failure to disclose the trading to the source of the information that is the critical deceptive act.\footnote{112}

The Court, however, could not make this distinction without also making some startling concessions. First, the *O'Hagan* decision permits a fiduciary to trade on material, nonpublic information with the consent of the principal. Although the Court left open the question of whether Section 14(e) gives the Commission authority to prohibit trading on inside information about a tender offer even with the tender offeror's consent,\footnote{113} the Court placed trading authorized by a principal squarely outside the reach of Section 10(b).\footnote{114}

\footnote{111} *O'Hagan*, 117 S. Ct. at 2209 (citations omitted).

\footnote{112} The *O'Hagan* Court's version of the misappropriation theory follows the trajectory of a parallel line of circuit court cases that, in contexts other than insider trading, occasionally distinguish *Santa Fe*. In these cases, the courts find civil liability under § 10(b) in situations where a fiduciary's failure to disclose his breach of duty harms the plaintiff, for example by resulting in loss of a state remedy. See, e.g., Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977) (finding a violation of Rule 10b-5 where a corporation was influenced by its controlling shareholder to engage in a transaction adverse to the corporation's interests and minority shareholders were induced into forgoing state law remedies by misleading disclosures), cert. denied, 434 U.S. 1069 (1978). See also Estate of Soler v. Rodriguez, 63 F.3d 45 (1st Cir. 1995) (holding that concealment by directors of information that stock was being issued and sold for an unfairly low price to an entity in which the directors were interested was actionable under § 10(b)); Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977) (holding corporate insider's failure to disclose material information to independent shareholders whose approval was needed under state law for a transaction with the insider to be actionable under § 10(b)), cert. denied, 434 U.S. 1066 (1978). None of these cases is cited in *O'Hagan*, but the mode of analysis is much the same (breach of fiduciary duty plus failure to disclose the breach equals violation of § 10(b)). Other courts, noting the tension with *Santa Fe*, have been more reluctant to adopt this approach. See, e.g., Harris Trust & Sav. Bank v. Ellis, 810 F.2d 700, 704 (7th Cir. 1987) ("More recent cases . . . reflect dissatisfaction with these holdings, because they use the securities laws to redress substantive violations of state law."); O'Brien v. Continental Illinois Nat'l Bank & Trust Co., 593 F.2d 54, 60-61 (7th Cir. 1979).

\footnote{113} As the *O'Hagan* Court observed:

We leave for another day, when the issue requires decision, the legitimacy of Rule 14e-3(a) as applied to "warehousing," which the Government describes as
Second, a fiduciary is permitted to trade even without the principal's consent so long as disclosure is made to the principal first, hence the title of this Article, "Don't Ask, Just Tell":

Similarly, full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.115

Once the intent to trade is disclosed to the principal, the trading is legal under Section 10(b), no matter how strenuously the principal objects.116 Thus, if O'Hagan had told his law firm and its client that he was trading before he did so, he presumably would not have violated the statute.

"the practice by which bidders leak advance information of a tender offer to allies and encourage them to purchase the target company's stock before the bid is announced." As we observed in Chiarella, one of the Commission's purposes in proposing Rule 14e-3(a) was "to bar warehousing under its authority to regulate tender offers." The Government acknowledges that trading authorized by a principal breaches no fiduciary duty. The instant case, however, does not involve trading authorized by a principal; therefore, we need not here decide whether the Commission's proscription of warehousing falls within its § 14(e) authority to define or prevent fraud.

O'Hagan, 117 S. Ct. at 2217 n.17 (citations omitted).

115 Id. at 2209.

116 Id. The government had already conceded this point at oral argument:

As counsel for the Government stated in explanation of the theory at oral argument: "To satisfy the common law rule that a trustee may not use the property that [has] been entrusted [to] him, there would have to be consent. To satisfy the requirement of the Securities Act that there be no deception, there would only have to be disclosure."

Id. at 2208 (alterations in original).

116 As the Court points out, the trading might, however, give rise to a breach of duty claim under state law. See id. at 2209.

Presumably, the Court's pronouncement that insider trading liability is negated by disclosure to the trader's principal applies to the classical theory of insider trading (applicable to corporate insiders and temporary insiders) as well as to the misappropriation theory. The principal to whom disclosure of the insider's intent to trade should be made is arguably the public shareholders themselves (in which case the "inside" information would no longer be nonpublic information). However, a corporate insider, and particularly a temporary insider, might be justified in disclosing only to a corporate officer or to the directors empowered to act on behalf of the corporation.
Third, the government conceded at oral argument that if the information used had been stolen by a person not standing in a fiduciary relationship with the source, there would have been no violation;117 thus thieves, industrial spies and other nonfidiaries who wrongfully obtain information do not come within the ambit of the statute. The Court's opinion in O'Hagan does not explicitly concede this point, but it does so impliedly by emphatically stating that the misappropriation theory requires both a prior fiduciary relationship and deception of the principal by the fiduciary.118

c. Misappropriation "in connection with" the Purchase or Sale of a Security

Finally, the deception required by Santa Fe must be "in connection with" the purchase or sale of a security.119 O'Hagan's misappropriation, even if deceptive, arguably was not "in connection with" the purchase or sale of a security as that phrase has previously been interpreted by the Court.120 The most natural reading of this statutory language covers manipulation of a securities market or attempts to deceive a participant in securities markets. O'Hagan's conduct fit neither category. If anyone was deceived (as the court defined deception), it was only his employer and the employer's clients, not a person who purchased or sold securities when O'Hagan did.

As described below, both the majority and the dissent clearly struggled with this statutory element in seeking to identify precisely what O'Hagan misappropriated, when O'Hagan's misappropriation occurred, and how close the misappropriation was to his

117 United State Supreme Court Official Transcript, O'Hagan (No. 96-842), available in 1997 WL 182584 at *5 ("QUESTION: Well, Mr. Dreeben, then if someone stole the lawyer's briefcase and discovered the information and traded on it, no violation? MR. DREEBEN: That's correct, Justice O'Connor.").
118 O'Hagan, 117 S. Ct. at 2207.
119 Santa Fe, 430 U.S. at 471 (quoting Section 10(b)).
120 See Jill E. Fisch, Start Making Sense: An Analysis and Proposal for Insider Trading Regulation, 26 Ga. L. Rev. 179, 195-96 (1991) ("The Court [in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975),] restricted the class of actionable claims under 10b-5 to those in which the fraud resulted in the purchase or sale of stock by the victim. . . . [T]his connection between the fraud and the securities transaction has been completely eviscerated in cases applying the misappropriation theory.") (footnotes omitted).
purchase of securities. For both the majority and dissent, a conceptual dilemma stems from the theory's failure to address two characteristics of the "thing" which O'Hagan presumably misappropriated—information—which distinguish it from most other forms of property.

First, because information is intangible, it is difficult to protect from discovery by others unless the possessor keeps the information to herself, sharing it with no one.\footnote{See Pamela Samuels, Information as Property: Do Ruckelshaus and Carpenter Signal a Changing Direction in Intellectual Property Law?, 38 Cath. U. L. Rev. 365, 369 (1989) ("[I]nformation is very difficult to maintain in any exclusive manner unless kept secret by its discoverer or possessor. Although one can bind another in confidence not to disclose information, that bond is very different from placing a physical object under lock and key.").} Furthermore, such "exclusive" use of information by the possessor is usually impossible. For example, information about an intended tender offer must be shared with lawyers, accountants, and investment bankers in order for the tender offer to become a reality.

Second, information is a public good. Like many public goods, its use by one or more persons does not reduce the amount remaining for use by others.\footnote{See id. at 371; see also James Boyle, A Theory of Law and Information: Copyright, Spleens, Blackmail, and Insider Trading, 80 Cal. L. Rev. 1413, 1438 (1992) ("I explain Pythagoras' theorem to you, or teach you how to work out the area of a circle. Afterwards, I seem no poorer in the sense that we both have the knowledge.").} Persons may use information in a way that facilitates or hinders its use by others, but not because the information comes in limited quantities. Despite the fact that information is both intangible and a public good, our language and sometimes our laws foster the misconception that information is instead tangible and finite. It is often said, for example, that a person "has" information, either because it was "given" to her or because she "stole" or "misappropriated" it.

The majority in O'Hagan treats information as tangible and finite at the outset, when it defines the misappropriation theory: "Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."\footnote{O'Hagan, 117 S. Ct. at 2207.} The majority then embeds itself further in this mode of analysis when it looks to the mail fraud
convictions upheld in *Carpenter* for guidance: "A company's confidential information, we recognized in *Carpenter*, qualifies as property to which the company has a right of exclusive use,"124 and "[t]he undisclosed misappropriation of such information, in violation of a fiduciary duty, the Court said in *Carpenter*, constitutes fraud akin to embezzlement—"the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another."125

Having used an embezzlement analogy to establish that there was a "fraudulent appropriation," the Court then backs itself out of this analogy in order to demonstrate that O'Hagan's misappropriation of information was necessarily linked to his trading, and therefore was "in connection with" a purchase or sale of securities. The Court attempts to distinguish O'Hagan's misappropriation from embezzlement of money by asserting that information, unlike money, is "ordinarily" only valuable because it can be used in securities trading.126 Thus, if money is embezzled:

"[T]he proceeds would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained." In other words, money can buy, if not anything, then at least many things; its misappropriation may thus be viewed as sufficiently detached from a subsequent securities transaction that § 10(b)'s "in connection with" requirement would not be met.127

This distinction, and the government's overstatement in its brief that trading in the stock market was the "only" use to which such information could be put,128 induced a skeptical Justice Clarence Thomas, joined in his dissent by Chief Justice William Rehnquist, to posit a parade of hypothetical scenarios in which O'Hagan could

---

124 Id. at 2208 (citing *Carpenter v. United States*, 484 U.S. 19, 25-27 (1987)).
125 Id. (quoting *Carpenter*, 484 U.S at 27).
126 Id. at 2210.
127 Id. at 2209 (citations omitted) (quoting Brief for the United States at 24 n.13).
128 The majority stated of the dissent:
The dissent does catch the Government in overstatement. Observing that money can be used for all manner of purposes and purchases, the Government urges that confidential information of the kind at issue derives its value only from its utility in securities trading. Substitute "ordinarily" for "only," and the Government is on the mark.
Id. at 2210 (citations omitted).
have used the misappropriated information about the Pillsbury tender offer without trading in securities.\footnote{129} For example, O'Hagan “could have sold it to a newspaper for publication; he could have given or sold the information to Pillsbury itself; or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game.”\footnote{130} Although the dissent’s hypotheticals expose the conceptual weakness of linking satisfaction of Section 10(b)’s “in connection with” requirement to the supposedly unique “use” of misappropriated information for securities trading, the dissenters are even more entwined than the majority in the conceptual trap of viewing information as a tangible and finite “thing” to be “taken” and then “used” for certain purposes. The dissent’s hypotheticals, and the majority’s even more speculative refutation of them in a footnote,\footnote{131} focus on distinctions that are largely irrelevant. Indeed, the absurdity of this colloquy between the majority and the dissent on the hypothetical “uses” of confidential information demonstrates the extent to which both fail to discern how the essential nature of information distinguishes its misappropriation from the theft of money and the subsequent use of that money to trade in securities.

The critical distinction is far more fundamental than the use to which the thing that is misappropriated (information or money) can be put. O'Hagan never in the first place “took” the information in the sense that an embezzler “takes” money, because information, being intangible and a public good, is not an object of which O'Hagan could deprive Grand Met of possession. The majority begins to grasp this distinction when it discusses the timing of O'Hagan’s misappropriation of information rather than the uses to which the information could be put:

\footnote{129} See id. at 2223 (Thomas, J., dissenting).
\footnote{130} Id. (citations omitted).
\footnote{131} “It is imaginative to suggest that a trade journal would have paid O'Hagan dollars in the millions to publish his information.” Id. at 2210 n.8. The majority found it equally unlikely that O'Hagan could have given or sold the information to Pillsbury: Pillsbury might well have had large doubts about engaging for its legal work a lawyer who so stunningly displayed his readiness to betray a client’s confidence. Nor is the Commission’s theory “incoherent” or “inconsistent” for failing to inhibit use of confidential information for “personal amusement . . . in a fantasy stock trading game.” Id. (citations omitted).}
[The "in connection with"] element is satisfied because the fiduciary’s fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information. A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public.\footnote{O’Hagan, 117 S. Ct. at 2209. Once again, the Court acknowledged that the deception necessary to trigger a violation of the statute is on a person other than the investors whom the statute is primarily designed to protect. The “harm” to investors that coincides with this deception of a third party links the misappropriation theory with the overall purpose of the statute, but is still entirely distinct from the breach that is the linchpin of the violation.}

This argument recognizes that O’Hagan’s breach of duty has nothing to do with whether he innocently or deceitfully learned the information about the impending tender offer. His carrying the knowledge in his head violated no law. His act of deception, of wrongdoing, of misappropriation, occurred only when he purchased Pillsbury stock on the basis of this knowledge. His misappropriation is therefore connected to the securities trade because it is the act of trading securities. In contrast, if an embezzler buys stock with the funds he embezzled, his action is not a violation of Section 10(b): His misappropriation occurred at the moment the funds were stolen, regardless of his purpose in executing the theft. His act of wrongdoing—taking the money—is not an act of securities trading and thus is not “in connection with the purchase or sale of a security.”\footnote{While the Court thus satisfied the “in connection with” requirement in the statute by equating the breach with the securities transaction, it did so by losing track of what was misappropriated. It is difficult to ascertain exactly what was misappropriated from Grand Met. Perhaps O’Hagan misappropriated the right to profit from the information, although this conclusion should require a showing that O’Hagan’s trades somehow reduced Grand Met’s profits.} Justice Thomas’s hypotheticals do not begin to address the majority’s argument because he cannot avoid the misconception that O’Hagan, like an embezzler, “took” information and then, in a separate act, traded on that information.
Consider, however, the hypothetical situation of a trustee in charge of the investment of trust funds. The trust terms provide that the trustee can invest the funds however she likes, even sew them into her mattress, so long as she does not use them to trade securities. The trustee violates the trust by buying stocks. Her sole act of wrongdoing is a securities purchase. Unlike in the embezzler hypothetical used by the O'Hagan Court, the act of purchasing securities, not the act of “taking” the money, is the violation. Under Justice Ginsburg's analysis, the trustee has committed fraud in connection with the purchase or sale of a security in violation of Section 10(b) because the trustee has wrongfully taken the property of the principal and used it to trade without informing the principal. Few would argue, however, that the trustee’s actions are prohibited by Section 10(b). The trustee’s actions may harm the beneficiaries, but they in no way harm the securities market or prevent it from being fair and efficient. The trustee’s wrongful trading in securities may be unethical, or even criminal, but it is hardly a manipulative or deceptive device in connection with the purchase or sale of securities. Because both the majority and the dissent are limited by their misconceptions as to the nature of information, neither side ever fully distinguishes the misappropriation of information from our trustee’s embezzlement.

3. "Solving" the Problem

The O'Hagan Court struggles with the Santa Fe problem but does not satisfactorily resolve it. Only by ignoring the Santa Fe Court’s warning about immersing Section 10(b) jurisprudence in state fiduciary duty law can the O'Hagan Court reconcile itself to the misappropriation theory’s equating of fiduciary breach with "deception."134 The Court defines the “deception” required to implicate the theory with parameters that are barely consistent with those set forth in Santa Fe,135 and then only by excluding from the misappropriation theory a wide range of conduct (such as trading with the permission of the principal but without disclosing to the market, trading without the permission of the principal after first disclosing to the principal, and trading on information that is stolen

134 See supra text accompanying notes 96-103.
135 See supra text accompanying notes 107-112.
from the principal by one who owes no fiduciary duty to the principal).\textsuperscript{136} Given the Court's insistence that trading covered by the misappropriation theory "harms members of the investing public,"\textsuperscript{137} it is difficult to understand how the Court can exclude from the theory's reach such conduct that has an identical effect on the investing public. Finally, the Court does not provide a satisfying explanation of how misappropriation covered by the theory is "in connection with" the purchase or sale of a security. The Court's discussion of this requirement does not distinguish misappropriation from a wide range of other fiduciary breaches that are obviously not covered by Section 10(b).\textsuperscript{138}

The Court was thus unable convincingly to "solve" the Santa Fe problem because the misappropriation theory and Section 10(b) as interpreted by Santa Fe are irreconcilable. The "deception" identified by the theory is simply a breach of fiduciary duty, and a breach of duty owed to, or even "deception" of, persons who are not trading at the time can hardly be said to occur "in connection with" the purchase or sale of a security. The Court's inquiry should have retained the focus of Chiarella and Dirks\textsuperscript{139} on those duties owed and not owed to issuers and investors rather than on those duties owed to third party entrustors of information. The Court had already limited its options when it rejected the equality of access theory in Chiarella.\textsuperscript{140} Once the Court decided that corporate outsiders in possession of material, nonpublic information have no duty to disclose that information to the persons with whom they trade, the Court foreclosed any logical way to reach trading by such outsiders under Section 10(b). A logical reading of the statute would have required the Court to reverse O'Hagan's conviction under Section 10(b), perhaps with a suggestion that if Congress did not like the result, it was up to Congress to amend the statute.

\textsuperscript{136} See supra text accompanying notes 113-118.
\textsuperscript{137} O'Hagan, 117 S. Ct. at 2209.
\textsuperscript{138} See supra text accompanying notes 120-133.
\textsuperscript{139} See supra text accompanying notes 40-53.
\textsuperscript{140} See supra text accompanying notes 40-43.
II. DIFFICULTIES ARISING FROM THE IMPRECISION OF THE MISAPPROPRIATION THEORY

A. Vague Case Law Under the Misappropriation Theory

As pointed out above, the Court in *Chiarella v. United States* rejected the equality of access theory primarily on the grounds that neither the language of Section 10(b) nor the legislative history evidenced a congressional intent to create such a broad duty to the market as a whole. However, the Court also noted that such a theory "would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity." Unfortunately, case law under the misappropriation theory has engendered much the same problem.

Since *Chiarella*, district and appellate courts have articulated various interpretations of the misappropriation theory. All have reached a narrower, more targeted, range of conduct than the equality of access theory. However, each court interpreting the theory has envisioned a target of different size and shape, making the misappropriation theory intolerably vague. Fines, lost careers, and even jail terms rest on an uncertain articulation of when fiduciary relationships exist and which parties to those relationships have a duty to disclose before trading on the basis of material, nonpublic information. This vagueness is compounded by courts' use of the misappropriation theory to target breaches of fiduciary duty that often have little to do with duties owed to participants in the securities markets, thus departing from the purposes for which the statute was enacted.

---

142 Id. at 233. Under the equality of access theory described and rejected in *Chiarella*, "[t]he use by anyone of material information not generally available is fraudulent . . . because such information gives certain buyers or sellers an unfair advantage over less informed buyers and sellers." Id. at 232.
143 Id. at 235 n.20.
144 See Elkan Abramowitz, Insider Trading: Another Chance for Clarity, N.Y. L.J., Nov. 5, 1996, at 3 (noting that the current unpredictability regarding the scope of the misappropriation theory "creates a fundamental unfairness to defendants who lack adequate notice of the legality and consequences of their actions"); Edward Brodsky, Insider Trading: The Misappropriation Theory, N.Y. L.J., Nov. 13, 1996, at 3, 7 (arguing that the case by case evolution of the misappropriation theory has led to confusion in an area where, given the possibility of criminal sanctions, certainty is needed).
Examples, both real and hypothetical, of the inconsistency generated by the misappropriation theory are plentiful. For example, consider in which of the following situations the trader is liable for trading on the basis of material, nonpublic information:

(1)(a) A psychiatrist buys or sells shares of BankAmerica Corporation after learning from a patient, the wife of the president of American Express, that her husband is seeking to become the Chief Executive Officer of BankAmerica;\textsuperscript{145} or (b) the same facts as above, but the wife passes the inside information to her hairdresser, rather than to her psychiatrist.\textsuperscript{146}

(2)(a) A corporate chief financial officer ("CFO") confesses to a priest that she has been manipulating the books of her company to increase earnings. The priest absolves the penitent of her sins and calls his broker to place a sell order; or (b) the same facts as above, but the CFO confesses her fraudulent conduct to a fellow parishioner from whom she seeks advice on whether to turn herself in. The fellow parishioner promises divine forgiveness and calls his broker.\textsuperscript{147}

(3)(a) The author of the "Heard on the Street" column in the Wall Street Journal trades on information learned in connection with research conducted for the column, in violation of a policy of his employer prohibiting such trading;\textsuperscript{148} or (b) the same facts as above, but the employer authorizes the author of the "Heard on the Street" column to trade on recommendations that the author intends to make the next day.\textsuperscript{149}

\textsuperscript{145} See United States v. Willis, 778 F. Supp. 205 (S.D.N.Y. 1991), in which the court denied a psychiatrist's motion to dismiss an indictment for insider trading based on the breach of the fiduciary duty owed by a psychiatrist to a patient.

\textsuperscript{146} The hairdresser example was taken from Jonn R. Beeson, Comment, Rounding the Peg To Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory, 144 U. Pa. L. Rev. 1077, 1137 (1996). Presumably no insider trading liability would attach to the hairdresser's trades, because the relationship between client and hairdresser does not give rise to a fiduciary duty under state law.

\textsuperscript{147} Following the logic of Willis, the priest is arguably guilty of insider trading under the misappropriation theory based on a breach of the fiduciary duty owed by a priest to a parishioner. Application of the misappropriation theory to the second situation, however, might require a court to delve into whether the person to whom the confession was made had a duty under applicable church doctrine not to disclose or use the information.


\textsuperscript{149} The trades presumably do not violate the § 10(b) insider trading prohibition as interpreted by O'Hagan. See O'Hagan, 117 S. Ct. at 2209.
(4)(a) Father, a board member of ABC Corporation, often discloses confidential information about ABC Corporation to his son, who purchases ABC call options,\textsuperscript{150} or (b) Wife, whose family founded and still controls ABC Corporation, tells her husband that the family has agreed to sell the business to an acquirer at a substantial premium over current market value. The next day, the husband instructs his broker to purchase shares of ABC Corporation.\textsuperscript{151}

(5)(a) An airline passenger entrusts his garment bag to airline employees at the airline ticket counter. A baggage handler, seeing papers describing a confidential merger transaction fall out of an open side pocket of the garment bag, reads them and calls his broker; or (b) another passenger steals the garment bag off the conveyor belt at the first passenger’s destination, reads the papers, and calls his broker.\textsuperscript{152}

The differing results in the above examples highlight a serious shortcoming of the misappropriation theory: Insider trading liability turns not on effects on the marketplace or on potential damage to selling or purchasing shareholders, but rather on a duty owed to the source of the information, regardless of whether that source is a buyer or seller of securities or even a market participant at all. Furthermore, even after eliminating the indeterminate “similar relationship of trust and confidence”\textsuperscript{153} part of the test and limiting the inquiry to fiduciaries in the traditional sense, the scope of fiduciary duty may still be defined by a variety of standards, including state fiduciary duty law, private agreement (as in the Wall Street Journal example), or the inherent nature of a professional or personal relationship (as in the parishioner, psychiatrist, and family

\textsuperscript{150} The facts of the father and son example are based on United States v. Reed, 601 F. Supp. 685 (S.D.N.Y.), rev’d on other grounds, 773 F.2d 477 (2d Cir. 1985), in which an allegation that the son breached a fiduciary duty to his father by trading on confidential information withstood a motion to dismiss.

\textsuperscript{151} The husband and wife example is derived from the facts of United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992), in which the court held that no fiduciary or similar relationship of trust and confidence existed between the husband and wife so as to give rise under the misappropriation theory to liability of the husband’s stockbroker as a “tippee.”

\textsuperscript{152} The government acknowledged in oral argument of the O’Hagan case that the misappropriation theory would not reach information that was stolen, absent a relationship of trust and confidence. United States Supreme Court Official Transcript, 1997 WL 182584, at *5, O’Hagan (No. 96-842), quoted supra note 117.
relationship examples). Unfortunately, the scope of fiduciary duties, particularly outside the traditional corporate insider context, is far from clear. Indeed, this lack of clarity raises concerns of constitutional proportion in the criminal context.

Adoption of the misappropriation theory will thus require the federal courts to embroil themselves not only in debate over the fiduciary duties of lawyers to their clients, but in similar debates over the fiduciary duties of accountants, appraisers, and investment bankers to their clients; doctors to their patients; taxi and limousine drivers to their passengers; newspaper columnists to their employers and their readers; professors to their students who work for law firms; priests, ministers, and rabbis to their parishioners; and so on. In each case, a federal court will have to analyze the particular relationship to determine whether a sufficient fiduciary relationship existed to send one of the parties to jail for misappropriation of information entrusted to her by the other.

B. The Uncertain Duties of an Attorney in Possession of Confidential Information

1. The Attorney's Use of Confidential Information

The attorney-client relationship is a good illustration of the ambiguity surrounding criminal liability dependent on breach of fiduciary duty. Indeed, O'Hagan's conduct did not unequivocally run afoul of the American Bar Association's ("ABA") Model Rules of Professional Conduct ("Model Rules"), Rule 1.8(b), which provides that "[a] lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the cli-

---

153 A fiduciary relation "need not be legal, but may be moral, social, domestic, or merely personal." Trustees of Jesse Parker Williams Hosp. v. Nisbet, 14 S.E.2d 64, 76 (Ga. 1941); see also Higgins v. Chicago Title & Trust Co., 143 N.E. 482, 484 (III. 1924) (same).


155 See infra text accompanying notes 175-179; Chestman, 947 F.2d at 570 ("Useful as such an elastic and expedient definition of confidential relations, i.e., relations of trust and confidence, may be in the civil context, it has no place in the criminal law.").
ent consents after consultation. Trading by a tender offeror’s attorney in the stock of a target, particularly in large quantities, could harm the client tender offeror by putting upward pressure on the price of the target company stock. On the other hand, the lawyer’s purchases could also help the client by putting more stock in friendly hands. If the latter were true, the lawyer arguably would not violate the Model Rules by trading without consulting the client first, because there would be no disadvantage to the client.

The American Law Institute (‘‘ALI’’) has also equivocated on this issue. Earlier drafts of the Restatement (Third) of the Law Governing Lawyers, like the Model Rules, only prohibited use of client information if the lawyer did so in a manner that harmed the client or if the client directed the lawyer not to use the information. Later drafts added the requirement that the attorney account to the client for profits made from use of client information. Although this provision discourages insider trading by requiring an accounting for profits, it is a failure to account for profits, not the trading itself, that is a breach of duty to the client. Furthermore, this Restatement rule would presumably allow a lawyer to whom a client owes money to trade and then use the profits to offset her bill, assuming the trading does not harm the client. These ambiguities make it difficult to condition a lawyer’s liability under the misappropriation theory on the lawyer’s duty to her client alone, and indeed the O’Hagan Court was careful to sidestep these problems by holding that O’Hagan had breached a duty to his law firm as well as to his client.

---

156 Model Rules of Professional Conduct Rule 1.8(b) (1995). For example, if a client intends to invest in certain real estate, the lawyer may not, without the client’s consent, acquire nearby property where doing so will adversely affect the client’s development plans. Id. at Rule 1.8 cmt.
157 See generally Bainbridge, supra note 90, at 7-16 (discussing the uncertain effects of insider trading on a client’s interests).
160 See O’Hagan, 117 S. Ct. at 2208.
2. The Attorney’s Disclosure of Confidential Information

Tipper and tippee liability under Section 10(b) can arise where a fiduciary improperly discloses, rather than directly uses, confidential information. The two legal doctrines concerning disclosure by an attorney, the attorney-client privilege and the attorney’s duty to preserve client confidences, vividly illustrate the gap between information a client may wish her attorney to keep confidential and information which is protected under the law. Both doctrines recognize that an attorney need not preserve a client’s confidences under all circumstances.

The attorney-client privilege and its various exceptions are usually not relevant to the insider trading problem (unless a judge trades on information learned in the process of determining whether the privilege shall apply). The duty to preserve client confidences, however, is important because it presumably precludes attorney “tips” of confidential client information to outsiders, including to persons who intend to trade on the information.

Nonetheless, the attorney’s duty to preserve client confidences does not neatly coincide with insider trading liability under Section

---

164 See Dirks v. SEC, 463 U.S. 646, 663-64 (1983) (holding that there is liability where the tippee both traded and knew that the tipper was breaching a duty by disclosing the information).

165 The duty to preserve confidences focuses on the lawyer’s ethical obligations, whereas the attorney-client privilege concerns the power of a court to compel testimony or production of documents. See John T. Noonan, Jr. & Richard W. Painter, Professional and Personal Responsibilities of the Lawyer 106 (1997). In some circumstances, for example, a lawyer could be compelled to testify about client secrets that he still should not willingly disclose to others. As the ABA Model Code of Professional Responsibility (“Model Code”) points out, “[t]he attorney-client privilege is more limited than the ethical obligation of a lawyer to guard the confidence and secrets of his client.” Model Code of Professional Responsibility EC 4-4 (1980). See also Noonan & Painter, supra, at 106 (quoting the Model Code); The Queen v. Cox and Ralton, 14 Q.B.D. 153, 168 (1894) (“In order that the [privilege] may apply there must be both professional confidence and professional employment, but if the client has a criminal object in view in his communications with his solicitor one of these elements must necessarily be absent.”). By contrast, lawyers, in circumstances other than where they are compelled to testify, generally have an ethical obligation to keep almost all of their clients’ secrets. See Model Rules of Professional Conduct Rule 1.6(b)(1) (1995) (setting forth a narrow exception to prevent a criminal act by the client that would likely result in imminent death or serious bodily harm); Model Code of Professional Responsibility DR 4-101(C)(3) (1980) (“A lawyer may reveal . . . [t]he intention of his client to commit a crime and the information necessary to prevent the crime.”).
10(b), even under the misappropriation theory. In some circumstances, a breach of the duty by an attorney who discloses client information to someone who trades on it does not bring liability under Section 10(b). For example, an attorney breaches the duty by disclosing client information to outsiders without permission from her client, but under the Supreme Court's holding in *Dirks v. Securities and Exchange Commission*, there is no liability under Section 10(b) unless the attorney also received some benefit in return for the tip. Thus, if O'Hagan, instead of trading, had become drunk at a bar and had then, without expecting anything in return for his loose lips, breached his duty to Grand Met by talking about the impending takeover of Pillsbury with a group of lawyers, all of whom traded on the information, nobody—neither O'Hagan nor the other lawyers who traded—would be liable under Section 10(b). If the transaction were not a tender offer, the federal securities laws would be irrelevant. Another example of the divergence between the misappropriation theory and the attorney's duty to protect client confidences is an attorney who escapes liability under the misappropriation theory simply by telling her client that she intends to breach her duty by disclosing material, nonpublic information to another person without the client's permission and share in the profits from the other person's trades.

In other circumstances, an attorney's duty to preserve client confidences is weak or nonexistent, but the impact on investors of trading by the attorney or her tippee is the same as it would be if

---


164 Id. at 662 ("Thus, the test is whether the [tipper] personally will benefit, directly or indirectly, from his disclosure."). See also SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla. 1984), in which University of Oklahoma football coach Barry Switzer traded on information that he overheard from a company officer who was discussing a transaction with his wife; following *Dirks*, the court held that insider trading liability under § 10(b) could not attach because the company insider did not profit from a breach of fiduciary duty. Id. at 766.

The required benefit, however, need not be pecuniary. Tippers may, for example, seek a reputational benefit or intend to benefit a particular recipient of information, such as a close friend or relative. See *Dirks*, 463 U.S. at 663-64.

165 See supra notes 54-55 and accompanying text.

166 The *O'Hagan* Court conceded that trading on client information is not prohibited in circumstances where the attorney informs the client in advance that the attorney intends to trade. 117 S. Ct. at 2208-09; see also supra notes 115-116 and accompanying text (discussing that aspect of *O'Hagan*).
the attorney clearly had such a duty.\textsuperscript{167} For example, a client's giving her attorney permission to use or disclose the client's material, nonpublic information allows the attorney to trade or tip without violating any ethical duty.\textsuperscript{168} An attorney also arguably may use client information for her own trades even without permission if the attorney's trading cannot be shown to have harmed the client.\textsuperscript{169}

Finally, the attorney’s duty of confidentiality is mitigated, if not eliminated, when the client imparts confidential information about the client's ongoing criminal and fraudulent conduct, ranging from income tax fraud and predatory pricing to stock market manipulation\textsuperscript{170} and embezzlement. In most cases, such information is only relevant to the value of a client issuer's own securities, putting the attorney who trades on such information while a temporary insider squarely within the reach of the classical insider trading theory. However, an attorney sometimes could use information about a client's illegal acts to trade in the securities of co-conspirators or victims of the client's conduct. In those cases does the client, which may also be trading with unsuspecting investors in the same securities, have a right to expect that its attorney will not trade on material, nonpublic information about the client's crimes? Alternatively, if the client has no right to expect that the information will be kept confidential,\textsuperscript{171} may the attorney trade or tip at will? Perhaps the

\textsuperscript{167}The *O'Hagan* Court assumes that trading on misappropriated information “harms members of the investing public.” *O'Hagan*, 117 S. Ct. at 2209. Some scholars agree, while others disagree. See supra notes 5, 21-23.

\textsuperscript{168}See supra text accompanying note 114; Model Rules of Professional Conduct Rule 1.8(b) (1995) (allowing attorney to use client information after consultation with the client and with her consent); Id. at 1.6(a) (allowing attorney to disclose client information with the client's consent).

\textsuperscript{169}If the attorney herself trades on the information instead of disclosing it to someone else who then trades, the more lenient Model Rule 1.8 applies instead of Model Rule 1.6, and even absent the consent of the client, there apparently is no ethical breach unless there is harm to the client from the attorney's trades. See Model Rules of Professional Conduct Rule 1.8(b) (1995). But see Restatement (Third) of the Law Governing Lawyers § 112(2) (Proposed Final Draft No. 1, 1996) (requiring the attorney to account to the client for profits made from use of client information).

\textsuperscript{170}For example, the client might inform her attorney that she intends to manipulate the price of another company's stock through matched orders, wash sales, and other devices prohibited by § 10(b) and other provisions of the 1934 Act.

\textsuperscript{171}See supra note 162 (discussing exceptions to the attorney's duty to keep client confidences in circumstances where death or serious bodily harm may result, Model Rules of Professional Conduct Rule 1.6(b)(1) (1995), or where disclosure is necessary
attorney should not trade on the information or tip someone who then trades on it, not because of a presumed duty to the corrupt client, but because he owes a duty to other market participants not to take advantage of his own client’s corruption for personal gain. This last approach may sound appealing, but is precluded, at least insofar as Section 10(b) is concerned, by the Court’s holdings in Chiarella and O’Hagan.

All of these examples involving an attorney’s fiduciary obligations with respect to confidential client information illustrate a more general point: There are extensive gaps between fiduciary duty law and Section 10(b)’s purposes. When the O’Hagan Court approved of the misappropriation theory, it left these gaps intact.

C. The Misappropriation Theory’s Vagueness as a Standard for Criminal Liability

As discussed below, Congress has declined to adopt language defining the circumstances under which trading on the basis of material, nonpublic information is prohibited, leaving courts to define those circumstances on a case-by-case basis. This common law development of criminal standards arguably violates general canons governing judicial construction of criminal statutes and implicates due process considerations articulated by the Court in other contexts. The O’Hagan Court brushed aside these concerns by simply stating that they did not apply to O’Hagan, who knew he was not supposed to trade. Although it is beyond the scope of this Article to define the limits of the courts’ role in defining criminal violations, some general observations may emphasize how troubling the ambiguities previously discussed in this Part can be in a criminal context.
The Court has consistently recognized that a statute prescribing criminal punishment must provide a definite standard of guilt: 175 "It is a basic principle of due process that an enactment is void for vagueness if its provisions are not clearly defined." 176 The preference against vague criminal laws rests on two basic premises. First, principles of fairness dictate that statutes imposing criminal liability be well defined. The Court has thus repeatedly insisted that laws defining unlawful conduct "give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly." 177 As the Court stated when first presented with the issue of "outsider" trading in Chiarella v. United States: "[A] judicial holding that certain undefined activities 'generally are prohibited' by § 10(b) would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity." 178 Second, in order to avoid arbitrary and discriminatory enforcement of criminal statutes, laws must provide explicit standards for those who apply them. 179

From these basic principles follow the three general canons, first articulated by Chief Justice John Marshall in United States v. Wiltberger, 180 that guide courts in the judicial construction of criminal

---

176 Grayned, 408 U.S. at 108.
177 Id. See also Connally v. General Constr. Co., 269 U.S. 385, 391 (1926) ("[T]he terms of a penal statute creating a new offense must be sufficiently explicit to inform those who are subject to it what conduct on their part will render them liable to its penalties . . . ."); Buckley v. Valeo, 424 U.S. 1, 77 (1976) ("Due process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal . . . .").
179 Grayned, 408 U.S. at 108-09 ("A vague law impermissibly delegates basic policy matters to policemen, judges, and juries for resolution on an ad hoc and subjective basis, with the attendant dangers of arbitrary and discriminatory application.").
statutes. The first canon of judicial construction of criminal statutes is that the legislature, not the judiciary, has the power to define crimes and establish punishments for their violation. This canon rests not only on the basic principle of separation of powers, but on due process concerns as well. In other words, because judicial lawmaking is necessarily accomplished on a case-by-case basis, it raises the danger of retroactive creation of criminal laws and punishments. In United States v. Kozinski, the Court noted:

> It is one thing to recognize that some degree of uncertainty exists whenever judges and juries are called upon to apply substantive standards established by Congress; it would be quite another thing to tolerate the arbitrariness and unfairness of a legal system in which the judges would develop the standards for imposing criminal punishment on a case-by-case basis.

The second canon of judicial construction of criminal statutes, the “rule of lenity,” dictates that ambiguity concerning the scope of a criminal statute be resolved in favor of the defendant. The principles underlying the rule are “to promote fair notice to those subject to the criminal laws, to minimize the risk of selective or arbitrary enforcement, and to maintain proper balance between Congress [and the] courts.” The third canon of judicial construction

---

181 See Bouie v. City of Columbia, 378 U.S. 347, 362-63 (1964) (reversing a criminal conviction sustained by the South Carolina Supreme Court by concluding that the broad judicial interpretation of the criminal statute at issue created an ex post facto effect and violated Wilberger).


183 Id. at 951.

184 See Wilberger, 18 U.S. (5 Wheat.) at 96. For examples of the rule applied, see United States v. Granderson, 511 U.S. 39, 54 (1994) (“Where text, structure, and history fail to establish that the Government’s position is unambiguously correct—we apply the rule of lenity and resolve the ambiguity in [defendant’s] favor.”), United States v. Thompson/Center Arms Co., 504 U.S. 505, 517-18 (1992) (plurality) (invoking the rule of lenity to resolve an ambiguity in a tax statute in defendant’s favor), Crandon v. United States, 494 U.S. 152, 168 (1990) (applying the rule of lenity to resolve ambiguity in favor of the defendant), and Kozinski, 487 U.S. at 952 (same).

185 Kozinski, 487 U.S. at 952. The rule of lenity also saves ambiguous criminal statutes from constitutional attacks while at the same time enforcing the will of Congress to the maximum extent possible. “Federal crimes are defined by Congress and so long as Congress acts within its constitutional power in enacting a criminal statute, [the courts] must give effect to Congress’ [will].” Id. at 939. For this reason, courts will whenever possible adopt a construction that resolves any ambiguities in favor of
of criminal statutes holds that criminal statutes must be strictly construed. As Chief Justice Marshall stated in Wiltberger, "[t]o determine that a case is within the intention of a statute, its language must authorize us to say so."

Unfortunately, the Court in O'Hagan collapsed its analysis of these issues into an observation that scienter is necessary before a defendant may be convicted for Section 10(b) violations. The Court explained: "To establish a criminal violation of Rule 10b-5, the Government must prove that a person 'willfully' violated the provision. Furthermore, a defendant may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the rule." Because O'Hagan's alleged conduct, although not unequivocally a violation of the ABA's Model Rules, was a clear breach of a fiduciary duty owed to his employer, he could legitimately argue lack of notice only if the validity of the misappropriation theory was so uncertain at the time that to apply the theory to any criminal defendant would violate due process. Not surprisingly, O'Hagan's lawyers made such an argument before the Court. The majority in O'Hagan found this position implausible as it applied to O'Hagan, a partner in a large law firm representing public corporations, and said little to address the due process problems that could be presented by application of the misappropriation theory to other categories of defendants.
As demonstrated by the hypotheticals in Section II.A, however, the full reach of the misappropriation theory is far from clear, particularly when applied to relationships not falling into one of the traditional categories of common law fiduciary duty. It is likely that, as the Commission and the lower courts continue their attempts to broaden the cast of characters to whom the misappropriation theory may be applied, other defendants will invoke the due process argument, quite possibly with more success than that achieved by O'Hagan.

III. CONGRESS'S FAILURE TO DEFINE ILLEGAL TRADING ON MATERIAL, NONPUBLIC INFORMATION

A. The 1984 and 1988 Legislation

In 1984, Congress enacted the Insider Trading Sanctions Act of 1984\(^{139}\) (the "1984 Act") which, among other things, made it illegal to trade options and other derivative securities in circumstances where it would be illegal to trade in the underlying security.\(^{194}\) The loophole closed by this provision is obvious: A corporate insider or her tippee should not be allowed to circumvent Section 10(b) by trading in options instead of the underlying security. This provision suggests that Congress was aware of the limited reach of the classical insider trading theory under Section 10(b), which some courts had held did not cover trades between a corporate insider and options dealers to whom he owes no fiduciary duty.\(^{195}\) The 1984 Act also implies that Congress knew how to expand the reach of the 1934 Act's insider trading prohibition when it wanted to.\(^{196}\)

---


\(^{140}\) Id. at § 5, 98 Stat. at 1265.


\(^{139}\) Amici in support of the Government in O'Hagan instead interpreted this amendment to have "generalized the misappropriation theory" under § 10(b) because it imposed a prohibition even though "corporations and their insiders do not owe fiduciary duties to those who own or trade options on corporate securities when those options are issued by others." Brief of Amici Curiae North American Securities Administrators Association, Inc., and Law Professors in Support of Petitioner at
In the legislative hearings in connection with the passage of the 1984 Act, several witnesses testified that the committee should add to the bill specific language defining the scope of the prohibition against trading on the basis of material, nonpublic information.\textsuperscript{197} Congress, however, at the urging of the Commission,\textsuperscript{198} did not enact a definition of insider trading.

In 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988\textsuperscript{199} (the "1988 Act"). In the 1988 Act, Congress added Section 20A to the 1934 Act, providing a remedy for contemporaneous traders in the same security against "[a]ny person who violates any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information."\textsuperscript{200} Nowhere, how-


[T]he Committee believes that the Commission has used its broad rulemaking authority to respond to marketplace developments; that the adoption of a statutory definition could reduce flexibility; and that any new definition which might be adopted would be likely to create new ambiguities, thereby increasing rather than limiting uncertainty.

... Finally, the Committee believes that the adoption of a definition (which would inevitably affect to some degree the substantive law) is not necessary to achieve the basic purpose of the bill: to increase the sanctions available under the law as it now exists and as it continues to evolve.


\textsuperscript{200} Id. at sec. 5, § 20A, 102 Stat. at 4680-81 (codified at 15 U.S.C. § 78t-1 (1994)).
ever, does the language of Section 20A expand the provisions of the 1934 Act to include a prohibition on trading while in possession of misappropriated information, despite the fact that Congress was aware that the Court had been evenly divided on the validity of the misappropriation theory in Carpenter.

The legislative history does indicate that Congress considered codifying the misappropriation theory in 1988. There was support in Congress for expanding insider trading liability beyond the classical theory—which prohibits trading only by corporate insiders, temporary insiders, and their tippees—and some members of Congress recognized the misappropriation theory as a means by which some courts had accomplished that end. For example, the House Committee on Energy and Commerce referred to the misappropriation theory as being “unresolved nationally” in the courts and suggested that “this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5.”201 Congress did not, however, act to include the misappropriation theory or any other definition of illegal trading on the basis of material, nonpublic information in the 1934 Act, despite the fact that some members of Congress recognized that a definition was needed. For example, Senator Alfonse D’Amato, in introducing the Insider Trading Proscriptions Act of 1987, observed that:

[T]he present state of uncertainty about the law is simply not acceptable. The ambiguities about the law were vividly demonstrated in subcommittee hearings earlier where members of the securities industry and securities bar could not specify what conduct constituted insider trading and what conduct is permissible. I believe that an “I know it when I see it standard” is totally unacceptable.202

The one thing that is clear with respect to Congress’s actions in 1988, as in 1984, is that Congress ultimately decided to leaveSection 10(b) alone.203

203 The remedy enacted in 1988 has little connection with the misappropriation theory. It is contemporaneous traders, not third parties alleging misappropriation of confidential information, who are entitled to sue under § 20A. Disjuncture between the misappropriation theory and Congress’s objective of protecting investors has thus caused a glaring incongruence between the remedy given to market participants in
B. Congressional Inaction as No Action

Regardless of what Congress thought about Section 10(b) in 1984 and 1988, the legislative maneuverings of those years not only failed to define insider trading, but also provided no persuasive guidance on the issue for the courts. Congress accomplished little in 1984 and 1988 by stating in committee reports what the law should be. To have any meaningful effect on Section 10(b), Congress will have to amend the statute itself or let the Commission and the courts continue to discern the intent of the 1934 Congress.

Both the Court's prior opinions and its holding in O'Hagan suggest that the text of the statute controls. Earlier, the Court stated: "When the text of § 10(b) does not resolve a particular issue, we attempt to infer 'how the 1934 Congress would have addressed the issue . . .'" The O'Hagan Court in like manner approved of the misappropriation theory because it believed that O'Hagan's conduct was "manipulative or deceptive" within the meaning of the 1934 statute, not because it was the intent of subsequent Congresses to prohibit such conduct. Although arguments based on the 1984 and 1988 legislation were raised by the government in its brief, and in at least one amicus brief, the Court made clear in a footnote that it would not address the point.

1988 and the misappropriation theory's definition of the violation creating that remedy—a definition not only remarkable in its vagueness, but having little connection with the contemporaneous trader empowered to sue for the alleged harm.


205 See Petitioner's Brief at 32-35, O'Hagan (No. 96-842), available in 1997 WL 86306 (arguing that Congress intended to validate the misappropriation theory in enacting the 1988 Act).

Two relevant doctrines—the "re-enactment doctrine" and the even more speculative "acquiescence doctrine"—had already been raised before the Court in the context of Section 10(b) and rejected in *Central Bank v. First Interstate Bank.* With respect to the reenactment doctrine, the Court observed:

When Congress reenacts statutory language that has been given a consistent judicial construction, we often adhere to that construction in interpreting the reenacted statutory language. Congress has not reenacted the language of § 10(b) since 1934, however, so we need not determine whether the other conditions for applying the reenactment doctrine are present.

The acquiescence doctrine also held little favor in the Court's Section 10(b) jurisprudence. The respondents in *Central Bank* had urged the Court to expand the scope of the implied private right of action under Section 10(b) to include suits against aiders and abettors. They argued that "Congress has amended the securities laws on various occasions since [federal courts began to approve of aiding and abetting actions]. From that, respondents infer that these Congresses, by silence, have acquiesced in the judicial interpretation of § 10(b)." The Court rejected that argument also, observing that "Congressional inaction cannot amend a duly enacted statute." The Court concluded its discussion by stating in no uncertain terms that "[w]e find our role limited when the issue is the

---

200 See *O'Hagan*, 117 S. Ct. at 2214 n.11. The Court responded in like manner to the government's argument concerning § 14(e) and Rule 14e-3(a). Id. at 2219 n.22 ("Repeating the argument it made concerning the misappropriation theory, the United States urges that Congress confirmed Rule 14e-3(a)'s validity in the 1988 Act. We uphold Rule 14e-3(a) on the basis of § 14(e) itself and need not address [the 1988 Act's] relevance to this case.") (citations omitted).

201 511 U.S. 164 (1994).

202 Id. at 185 (citations omitted). "At least insofar as the re-enactment doctrine applies to cases arising under Rule 10b-5, however, *Central Bank* places it in serious jeopardy." Bainbridge, supra note 31, at 1205.

203 511 U.S. at 186.

204 Id. (quoting *Patterson v. McLean Credit Union*, 491 U.S. 164, 175 n.1 (1989)). Furthermore, in *Central Bank*, the Court specifically rejected reliance on references to aiding and abetting liability in the 1983 and 1988 committee reports and reiterated that "[w]e have observed on more than one occasion that the interpretation given by one Congress (or a committee or Member thereof) to an earlier statute is of little assistance in discerning the meaning of that statute." Id. at 185 (quoting *Public Employees Retirement Sys. v. Betts*, 492 U.S. 158, 168 (1989)).
scope of conduct prohibited by the statute. That issue is our concern here, and we adhere to the statutory text in resolving it.\textsuperscript{212} Now that \textit{O'Hagan} has been decided without any reliance whatsoever on the work of Congresses after 1934, lower courts, in interpreting the misappropriation theory, are unlikely to depart from the mandate of \textit{Central Bank} and give significant weight to the intent of any Congresses that do not amend Section 10(b).

IV. HOW SHOULD THE COURTS DEFINE THE SCOPE OF THE MISAPPROPRIATION THEORY?

Notwithstanding the problems with the misappropriation theory, the Supreme Court is unlikely to revisit the issue soon, nor admit that it made a mistake.\textsuperscript{213} For this reason, determining how courts are likely to resolve the questions left by \textit{O'Hagan} is as important as understanding the conceptual weaknesses of the opinion.

The Supreme Court in \textit{O'Hagan} found that the language of Section 10(b) encompasses the misappropriation theory, but did not define the scope of the underlying fiduciary relationship giving rise to a duty to disclose material, nonpublic information.\textsuperscript{214} There are two approaches the Court could have taken, and that lower courts could still take, to define a fiduciary relationship giving rise to insider trading liability. First, federal courts could look to the relevant state law that defines and distinguishes fiduciary relationships from other relationships. Second, federal courts could develop a federal common law of fiduciary duty to steer federal securities law toward a uniform and coherent definition.\textsuperscript{215}

\textsuperscript{212} \textit{Central Bank}, 511 U.S. at 187-88 (citation omitted).

\textsuperscript{213} While it could not easily walk away from the core misappropriation theory adopted in \textit{O'Hagan}, perhaps the Court, if given a chance, would reject the “don't ask, just tell” aspect of its rationale by requiring consent from a principal for a fiduciary to trade, not merely disclosure to the principal of the fiduciary’s intent to trade.

\textsuperscript{214} See supra text accompanying notes 100-106.

\textsuperscript{215} The choice-of-law problem was discussed extensively by Professor Bainbridge prior to the \textit{O'Hagan} decision. See Bainbridge, supra note 31, at 1207-09. Courts adopting the misappropriation theory seemed to be creating a federal common law of confidential relationships without explicitly addressing the choice-of-law issue. See, e.g., United States v. Chestman, 947 F.2d 551, 570-71 (2d Cir. 1991) (en banc) (holding that marriage, without more, is not a fiduciary relationship with no discussion of choice of law), cert. denied, 503 U.S. 1004 (1992); SEC v. Singer, 786 F. Supp. 1158, 1169-70 (S.D.N.Y. 1992) (holding that an attorney is a fiduciary to his client without explicitly relying on state regulation of lawyers); United States v. Willis, 778
Incorporating state law fiduciary duty concepts as the linchpin of federal insider trading liability could lead to different results on similar facts in different states. One need only look at the different states’ views on the fiduciary character of marriage to understand the extent of this problem. While the Second Circuit held in United States v. Chestman that marriage per se does not give rise to a fiduciary relationship in New York, other courts have disagreed, but those courts do not agree as to when the fiduciary relationship begins and ends. Indeed, given the variations among state court decisions on this issue, liability for trading on material, nonpublic information would vary depending on whether one was unofficially engaged, officially engaged, married, happily married, negotiating a separation agreement, separated or divorced, and may even depend on whether confidential information was disclosed at a couple’s New York apartment or New Jersey country home. Similar concerns about predictability and consistency among courts borrowing state statutes of limitations for the implied private right of action under Section 10(b) led the Supreme Court in 1991 to impose a uniform federal statute of limitations. Such


216 This point was emphasized by the Fourth Circuit in rejecting the misappropriation theory in United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995).


218 Id. at 571.


220 See cases cited supra notes 218-219.

concerns should be dispositive when considering problems raised by borrowing state fiduciary law as well.\textsuperscript{222}

Developing a federal common law of fiduciary duty would provide a more effective approach and would better serve policies of predictability, consistency, and judicial economy than would incorporating state law fiduciary duty concepts into the federal rule of decision.\textsuperscript{223} In developing a federal common law of fiduciary duty, without commenting on the underlying choice-of-law decision being made, a number of courts adopting the misappropriation theory have relied upon the provisions of the Restatement (Second) of Agency ("Restatement") concerning a fiduciary's use of confidential information.\textsuperscript{224} The courts may find, however, that the Restatement's definitions are not complete for purposes of federal securities law, as the Restatement focuses on potential competition with or injury to the principal,\textsuperscript{225} not on potential injuries to investors with whom the agent trades. Thus, this approach would presumably reach purchases of a would-be tender offeror's target stock by a lawyer or accountant of the tender offeror, because the

\textsuperscript{222} Theresa Gabaldon has recently analyzed the inconsistent approaches to the use of state law in federal securities cases, from the use of "gap fillers" such as state statutes of limitations, to explicit incorporation of state law as the rule of decision. Theresa A. Gabaldon, State Answers to Federal Questions: The Common Law of Federal Securities Regulation, 20 J. Corp. L. 155 (1994). She reached the conclusion that development of federal common law is preferable for two reasons. First, reference to each state's agency law and contract law to define the source of the duty upon which trading liability would be founded could lead to confusion and forum shopping. Id. at 212-13. Second, as a general matter, "questions relating to the definition (as opposed to remedial consequences) of regulated conduct [under the federal securities laws] should be answered in uniform fashion throughout the country." Id. at 188.

\textsuperscript{223} Congress has also recently acted to preempt state "merit regulation" of securities offerings, an area which, prior to 1996, had been subject to concurrent state and federal regulation. See 15 U.S.C.A. § 77r (West 1996). This suggests a greater recognition on the part of Congress that, with respect to securities law, federal interests in uniform regulatory definitions sometimes predominate over competing state interests.


\textsuperscript{225} Section 395 of the Restatement (Second) of Agency prohibits agents from using or communicating confidential information of the principal "in competition with or to the injury of the principal," even if such information does not relate to the transaction in which he is then employed. Restatement (Second) of Agency § 395 (1958).
principal (tender offeror) could be injured by such an action. The Restatement approach, however, might not reach the facts of Chiarella, depending on how broadly the concept of "injuring the principal" is construed and indeed on who the principal is understood to be—Chiarella's employer, the financial printer, or its customer, the tender offeror. Nor would the Restatement approach necessarily reach the Wall Street Journal reporter in Carpenter, a judge's law clerk who traded on information contained in an opinion that had not yet been issued, or a Federal Reserve Bank employee who traded with knowledge of an imminent change in the margin rate. Thus, even in relying on the Restatement, courts would still need to grapple with key definitional issues, including who the principal is, how broadly to construe the concept of "injuring the principal," and what connection the investment transaction ought to have with the fiduciary relationship.

Moreover, we can anticipate that the types of relationships ultimately subject to the O'Hagan insider trading regime will continue to expand. Relationships of confidence often arise without being designated as such by the persons entering into them, and in most circumstances persons in a fiduciary relationship cannot simply choose to characterize their relationship as nonfiduciary. As Professor Kathleen Clark observes, "[c]ourts and legal scholars have applied the term "fiduciary obligation" to a wide range of relationships, including those between trustees and beneficiaries; guardians and wards; lawyers and clients; doctors and patients; agents and principals; directors and corporations; partners and other partners; and in some instances, employees and employers." Professor

224 Depending on the circumstances, however, the insider's actions might not injure the tender offeror. See supra note 157 and accompanying text.
225 See supra notes 64-70 and accompanying text.
226 Injury to the judiciary on the one hand, and to the Federal Reserve Board on the other, would be difficult to identify precisely in these examples, although both might suffer reputational injury from insider trading by their employees. See Fed. Sec. Code § 1603 cmt. 3(d) (1978) (suggesting a category of "quasi-insider" be developed to bring these types of traders within the ambit of prohibited trading on material, nonpublic information).
227 See Tamar Frankel, Fiduciary Law, 71 Cal. L. Rev. 795, 820 (1983) ("Once a relation is established ... its classification as fiduciary and its legal consequences are primarily determined by the law rather than the parties.") (footnotes omitted).
228 Kathleen Clark, Do We Have Enough Ethics in Government Yet?: An Answer from Fiduciary Theory, 1996 U. Ill. L. Rev. 57, 69 (footnotes omitted) (citing Re-
Clark seeks to expand the fiduciary paradigm to the relationship between government servants and the public they serve, and others have argued that a fiduciary relationship exists between students and teachers. Moreover, as Professor Tamar Frankel has pointed out, "[t]he twentieth century is witnessing an unprecedented expansion and development of the fiduciary law" as new types of relationships, formerly not characterized as fiduciary, are increasingly seen as incorporating essential elements of fiduciary power.

Once a relationship is defined as fiduciary for purposes of insider trading law, either under a federal common law of fiduciary duty or by incorporating state law concepts, a court must then decide whether the specific fiduciary relationship involves a duty to disclose to the principal before trading on confidential information. As the Supreme Court observed in Securities and Exchange Commission v. Chenery Corporation over fifty years ago: "[T]o say


231 Id.

232 See Timothy Davis, Examining Educational Malpractice Jurisprudence: Should a Cause of Action Be Created for Student-Athletes?, 69 Denv. U. L. Rev. 57, 94 (1992) ("Colleges and universities exercise dominion and control over the affairs of student-athletes. As such, a quasi-fiduciary relationship is created . . . ."); Ronna Greff Schneider, Sexual Harassment and Higher Education, 65 Tex. L. Rev. 525, 529 n.19, 552 (1987) (asserting that teachers have fiduciary obligations to students, particularly given the trust and dependency of students on their teachers). Presumably, under O'Hagan, a law professor whose student informs her that he cannot attend class because he is working on a merger transaction at a downtown law firm may not trade on the information if she is indeed a fiduciary for the student. Nonetheless, the fact that the student did not need to tell the professor specifics about the merger in order to seek an excuse from class attendance might place the communication outside of the scope of the fiduciary relationship. Furthermore, the communication might be illicit and contrary to the very purpose of the fiduciary relationship. The standards set forth by both the ABA and most law schools are clear, although also widely ignored: Students should not skip class to work during the term at law firms.

233 See Frankel, supra note 229, at 796.

234 Professor Frankel points to physicians and psychiatrists as recent "members of the fiduciary group." Id.

235 318 U.S. 80 (1943).
that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations?226

As pointed out in the above discussion of the attorney-client privilege and attorney-client confidences, not all fiduciary relationships involve confidential information, and not all information is or should be confidential.227 Furthermore, a fiduciary who receives confidential information from her principal may receive the information outside the scope of the fiduciary relationship, giving rise to difficult issues of fact and concerns about the appropriateness of insider trading liability.228

Finally, under either the state or federal common law approach, the misappropriation theory will take Section 10(b) jurisprudence into fiduciary duty law, the Court’s concerns in Santa Fe Industries v. Green229 notwithstanding. Judicial opinions developing the misappropriation theory will struggle to resolve the tension between the need for a uniform body of fiduciary duty law and the cautionary approach adopted by the Court in Santa Fe.230

226 Id. at 85-86. In Cheney, the Supreme Court (in an opinion by Justice Felix Frankfurter) upheld a decision of the Court of Appeals for the District of Columbia setting aside an order by the SEC. The SEC’s order had refused to permit respondents (officers, directors, and controlling shareholders, who were also preferred shareholders of a holding company) to participate in a reorganization under the Public Utility Holding Company Act of 1935 on an equal basis with other preferred shareholders because of the SEC’s analysis of the strictures imposed by the respondents’ fiduciary duties. The Court disagreed about the content of the officers’ fiduciary duties, holding that “the courts do not impose upon officers and directors of a corporation any fiduciary duty to its stockholders which precludes them, merely because they are officers and directors, from buying and selling the corporation’s stock,” id. at 88, so long as the fiduciaries were not misusing their corporate position or informational advantages to the disadvantage of the corporation or its other stockholders. Id. at 93.

227 See supra Subsection II.B.2.

228 Lawyers, for example, are often prohibited from disclosing confidential information “relating to representation of a client.” Model Rules of Professional Conduct Rule 1.6(a) (1995). Information that does not relate to the representation is presumably outside the reach of the prohibition.

229 430 U.S. 462, 479 (1977). The Court in Santa Fe eschewed such a role for the federal courts applying federal securities law because of federalism concerns, id. at 478-79, and because the language of § 10(b) and Rule 10b-5 does not address breaches of fiduciary duty that do not also constitute deceptive conduct in a securities transaction. Id. at 472-74.

230 The Court stated:
V. THE NEED FOR THE COMMISSION OR CONGRESS TO DEFINE WHEN IT IS ILLEGAL TO TRADE ON THE BASIS OF MATERIAL, NONPUBLIC INFORMATION

Virtually every other country that has joined the United States in prohibiting trading on the basis of material, nonpublic information has done so through statutes that define with specificity such terms as "insider" and "inside information" as well as the circumstances in which trading is prohibited. The United Kingdom, for example, enacted a specific prohibition in 1980.24 Italy did so in 1991,25 and Germany followed in 1994.26 The United States stands

---

Federal courts applying a "federal fiduciary principle" under Rule 10b-5 could be expected to depart from state fiduciary standards at least to the extent necessary to ensure uniformity within the federal system. Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.

Santa Fe, 430 U.S. at 479 (footnote omitted). Moreover, O'Hagan authorizes an even more substantial federalization of state law than was at issue in Santa Fe. While Santa Fe involved alleged breach of corporate law fiduciary duties by corporate directors and officers, O'Hagan potentially implicates any fiduciary relationship.

24 The Companies Act, 1980, ch. 22, §§ 68-73 (Eng.), reassembled in The Criminal Justice Act, 1993, ch. 36, §§ 52-64 (Eng.). The statute: prohibits an insider from trading (1) on the basis of unpublished price-sensitive information, (2) in the securities of the company of which he is an insider, (3) on a recognized stock exchange or in off-market transactions if information regarding the price of such securities has been recently published. For this purpose, an insider of a company is an individual (not a corporation) who is, or within the preceding six months has been, a director, officer or employee of the company, or otherwise engaged in a professional or business relationship with the company.

Ronald E. Bornstein & N. Elaine Dugger, International Regulation of Insider Trading, 1987 Colum. Bus. L. Rev. 375, 389-90 (1987) (footnotes omitted). The statute's prohibition against trading on the basis of inside information by an insider of the company applies if the insider acquired such information by virtue of his connection with such company and also applies to transactions by an insider of one company in securities of another company on the basis of information regarding the occurrence or failure of a proposed transaction (such as a takeover or material contract) between the two companies.


alone in allowing judges to develop a common law prohibition against insider trading, and now against trading on the basis of misappropriated information, from a general antifraud statute that does not even mention insiders, inside information, insider trading, or misappropriation. The Supreme Court’s analysis, or perhaps lack of analysis, of Section 10(b) in *Chiarella*, *Dirks*, and now *O’Hagan*, makes a compelling case that the United States should abandon its common law approach to trading on material, nonpublic information and follow Europe by incorporating a more specific prohibition into either the Commission’s rules or the statute itself.

---


See also Ursula C. Pfeil, Comment: Finanzplatz Deutschland: Germany Enacts Insider Trading Legislation, 11 Am. U. J. Int’l L. & Pol’y 137 (1996) (discussing how, after 25 years of ineffective voluntary compliance with insider trading restrictions, Germany in 1994 enacted the Wertpapierhandelsgesetz [Law on Securities Trading], embodied in a more general legislative reform designed to make Germany’s financial markets more attractive to investors). Following the directive of the EC, Germany’s statute extends its prohibition to primary insiders (certain designated categories of persons who have access to and knowledge of insider information) and, to a lesser extent, to secondary insiders (all other third parties who have knowledge of insider information). Pfeil, supra, at 156-57. The insider trading prohibition applies only to trading on information that meets three requirements: 1) The information is “non-public information;” 2) The information pertains to an issuer of securities or to the securities themselves; and 3) The “non-public information” is “capable of considerably influencing the value of an insider security if it were publicized.” Id. at 159.

The prohibition in Germany’s Insider Trading Law is threefold:

First, the law prohibits primary insiders from taking advantage of their knowledge of insider information to acquire or dispose of insider securities for themselves or others. Second, it prohibits primary insiders from informing or providing others with access to the insider information without authorization. Third, the law prohibits primary insiders from using their knowledge of insider information to recommend to others the acquisition or sale of insider securities. Id. at 162-63 (footnotes omitted). Only the first of these prohibitions applies to secondary insiders. Id. at 163.

26 This is particularly ironic in view of the fact that most of the insider trading statutes adopted in other countries have their origins in pressure put on the governments of those countries by the SEC. See Paul G. Mahoney, Securities Regulation By Enforcement: An International Perspective, 7 Yale J. on Reg. 305, 314-15 (1990).
A. The Commission

Following O'Hagan, the Commission has wide latitude to define illegal trading on the basis of material, nonpublic information. It may do so either through enforcement proceedings or, more uniformly, through administrative rules amending or supplementing the prohibition of Rule 10b-5. Under Chiarella, any new prohibition promulgated by the Commission under Section 10(b) must involve deception, and may not require disclosure by persons who have no preexisting duty to disclose.24 The duty to disclose that the O'Hagan Court imposes on persons in fiduciary relationships, however, gives the Commission a wide range of rules to choose from if it decides to define more specifically when it is illegal to trade while in possession of material, nonpublic information.

The Commission could promulgate a rule, or at least an interpretive release covering Rule 10b-5, explaining what types of relationships are "fiduciary" for purposes of the misappropriation theory and what type of disclosure prior to trading will absolve a party to each type of relationship from liability under the rule. For example, the Commission might prohibit some categories of professionals who regularly deal in confidential information that is material to security prices—such as accountants, lawyers, investment bankers, financial printers, consultants, investment advisors, and stock brokers—from using confidential client information to trade without first disclosing use of the information to their client. These categories might also include persons in certain business relationships, such as partners or shareholders in a close corporation. The Commission might require this sort of fiduciary to disclose to the principal not only the fact that the fiduciary intends to trade, but also how much of the relevant security the fiduciary intends to buy or sell. The Commission could design a form that the fiduciary would complete and give to the principal before the fiduciary traded and then file with the Commission after the trading was completed.

Other professionals who do not regularly deal in confidential information that is material to security prices—such as doctors, psychiatrists, clergy, and teachers—might instead only be required to give oral notice to their principals of their intent to trade. They

24 See supra text accompanying notes 42-43.
might even be permitted to wait until after trading to disclose if the trades do not harm the principal—for example, if the trades are in small blocks that do not affect security prices.

Perhaps the most problematic category would be persons to whom the term “fiduciary” arguably does not apply. For example, while all employees are considered agents of their employers, giving rise to certain fiduciary duties, employees working outside of certain industries might not understand that their employer was entrusting them with confidential information. For example, a janitor working for a financial printer who sees papers in a wastepaper basket is more likely to understand that such information is confidential than is a janitor working at a Park Avenue co-op who happens to see open papers left outside an apartment door by a careless apartment owner. There is likewise a significant difference between a receptionist at a law firm who, helping a visitor with her coat sees papers drop out of the coat pocket, and a coat check person in a restaurant confronted with the same situation. These distinctions would be clarified if the Commission were to rule that employees working outside of certain specified industries where confidential information is regularly handled should not be liable under the misappropriation theory unless their employer has previously required them to sign an agreement prohibiting use of confidential information.

The status of independent contractors, such as taxi drivers, messengers, employees of overnight delivery services, and others is also problematic. Here also, a written confidentiality agreement should be required to implicate the misappropriation theory, so employees as well as employers know that trading is prohibited. The shoeshine man who regularly makes his rounds at Wall Street’s largest law firms should not be targeted for a Commission investigation of his trading activity, unless he is an employee of the law firm or has signed a confidentiality agreement with the law firm as a condition for being given access to the premises. All fiduciaries, not just those who intend to tip or trade, would benefit from such a clear distinction between persons who may and may not trade. For example, lawyers might feel free to discuss business in the back of a limousine under written contract with their firm that they would not discuss in the back of a cab.
Finally, certain categories of persons are not fiduciaries, and the Commission should make it clear that they will not be treated as such—for example, family members (who do not also have a business relationship with each other), friends, participants in discussion groups (Alcoholics Anonymous, Bible studies), and hairdressers.

One of the most troubling issues involves investment analysts, who insist that their research of specific companies and advice to clients must be distinguished from misuse of "inside" or "misappropriated" information. At the same time, many market participants believe it is unfair that certain favored analysts are given a "heads up" in closed door meetings and conference calls with corporate management while everybody else has to wait for a public announcement. The SEC has recognized this problem, and has occasionally brought proceedings against insiders for selective disclosure to analysts, but has also done relatively little to...
clarify when analysts may properly use material, nonpublic information and when they may not.\(^{250}\) Even in situations where an issuer has failed to disclose to investors information required to be disclosed under the 1934 Act’s continuous reporting provisions, the SEC has been reluctant to criticize the issuer for making its tardy disclosures first to securities analysts and then to public investors.\(^{251}\)

\(^{250}\) Occasionally, the SEC has prosecuted cases involving excessive “tipping” to securities analysts. SEC v. Stevens, Litig. Release No. 12,813, 48 SEC Docket 841 (Mar. 19, 1991) (describing charges brought against an ex-CEO for violating insider trading restrictions by selectively tipping securities analysts to enhance his professional reputation). More often, analysts are charged under the misappropriation theory when they use information for their personal gain, instead of using the information to advise their customers. See SEC v. Rosenberg, Litig. Release No. 12,986, 49 SEC Docket 1618 (Sept. 24, 1991) (relating charges of misappropriating information in violation of company policy against an analyst who sold his own shares in a company after learning from a routine conversation with an executive that the company was having difficulties with an important contract). See also Fox-Pitt, Kelton, Exchange Act Release No. 37,940, 63 SEC Docket 564 (Nov. 12, 1996) (claiming that broker-dealer Fox-Pitt failed to satisfy its obligation under 1934 Act § 15(f) to maintain and enforce procedures reasonably designed to prevent illegal use of material, nonpublic information when its personnel traded on the basis of material, nonpublic information learned from an analysts’ conference call). The 1934 Act’s § 15(f) provides that brokers and dealers are required to establish and enforce written policies and procedures “to prevent the misuse in violation of this chapter, or the rules or regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer.” 15 U.S.C. § 78o(f) (1994).

\(^{251}\) In 1992, for example, the SEC commenced proceedings under § 21C of the 1934 Act after finding that Caterpillar Inc. (“Caterpillar”) failed to comply with § 13(a) of the 1934 Act and Rules 13a-1 and 13a-13 thereunder. The SEC asserted that Caterpillar failed adequately to disclose in a 1989 10-K and a 1990 10-Q that 23% of Caterpillar’s net profits came from its subsidiary, Caterpillar Brasil, S.A. (“CBSA”), and that much of CBSA’s 1989 profits had resulted from factors such as currency exchange rates, interest rates, export subsidies, and tax loss carry forwards that would be very uncertain in future years. Caterpillar, Exchange Act Release No. 30,532, 51 SEC Docket 197 (Mar. 31, 1992).

Caterpillar was projecting a sharp decrease in profits by mid-1990 and, immediately before trading opened on Monday, June 25, 1990, issued a brief and undetailed press release stating “more than half of the decrease in forecasted 1990 profit is due to a dramatic decline in results for [CBSA],” causing a 2 1/8 point drop in Caterpillar’s stock from the previous closing price. Id. at 201.

During a telephone conference with stock analysts beginning at 1:00 p.m. on Monday afternoon, with the stock trading at 59 1/4, Caterpillar revealed CBSA’s importance to the company’s 1989 earnings and indicated that the parent company’s disappointing second quarter results were largely a product of circumstances in Brazil. On Tuesday, June 26, the day after the conference call, Caterpillar opened at 51 3/4, down 9 5/8 points from Monday’s opening price.

Id. The SEC found that Caterpillar should have disclosed the uncertainty surrounding CBSA’s earnings in the 1989 10-K and 1990 10-Q. Id. at 207. Curiously, how-
Does it make sense to regulate trading on misappropriated information when little is done to regulate the process by which corporate insiders themselves dispense information to market participants, some of whom are more favored than others?252 The Association for Investment Management and Research ("AIMR"), the premier association representing investment analysts and portfolio managers, filed an amicus brief in O'Hagan urging the Court to uphold the misappropriation theory of insider trading, but also urging the Court to protect the free flow of information to analysts.253 As Professor Jonathan Macey explains, when the equality of access theory appeared to be the law before Chiarella and Dirks were decided, "market professionals had very little incentive to press for stronger enforcement of the insider trading rules."254 After these decisions, "[w]hen the legal landscape changed so that market professionals could not be subject to prosecution for insider trading if they acted in the ordinary course of their employment and breached no fiduciary duties to shareholders, they urged and obtained stiffened penalties for insiders convicted of such violations."255 The arguments of investment analysts thus nicely fit into a broader paradigm in which professionals endorse laws that restrict others from engaging in a certain activity while proclaiming that a parade of horribles will ensue if the legal system does not maximize their own flexibility to engage in the same activity.256 

ever, the SEC, as Professor Edmund Kitch points out, "did not criticize Caterpillar for providing stock analysts preferred access to this information, disfavoring the public, nor did it bring proceedings on an insider-trading theory against anyone who sold as a result of the information revealed in the telephone conference." Edmund W. Kitch, The Theory and Practice of Securities Disclosure, 61 Brook. L. Rev. 763, 807 n.140 (1995); see also Paul P. Broutas Jr., Note, Rule 10b-5 and Voluntary Corporate Disclosures to Securities Analysts, 92 Colum. L. Rev. 1517 (1992) (discussing these issues).

252 See Fisch, supra note 120, at 229 ("Under existing insider trading law, securities analysts enjoy a position of distinct legal advantage over the general public because after Dirks, disclosure by corporate insiders to analysts for reasons other than personal gain will be treated as lawful.") (footnotes omitted).

253 Brief of Amicus Curiae Association for Investment Management and Research in Support of Petitioner at 6-17, O'Hagan (No. 96-842), available in 1997 WL 86305.

254 Macey, supra note 22, at 18.

255 Id.

256 Cf. Richard W. Painter, Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty, 71 Chi.-Kent L. Rev. 625, 639-40 (1995) (discussing champerty laws that prohibit nonlawyers from paying plaintiffs' legal expenses in re-
Professor Donald Langevoort has already written extensively about investment analysts and insider trading in this Law Review, 257 and we will not rehash the debate here. The SEC, however, will have to address these questions to assure the investment community that it is evenhandedly enforcing its prohibitions on insider trading. Returning to the "cheating" analogy, 258 every teacher knows what will happen if an honor code is not enforced or is enforced with partiality. Wall Street works the same way, and the Commission, in defining illegal insider trading, will need to specify how analysts may and may not use information obtained from company insiders.

B. Congress

If the Commission fails to define the parameters of illegal trading on material, nonpublic information, 259 Congress should enact a

turn for a share in litigation proceeds, while permissive regulation of contingent fees preserves lawyers' right to enter into similar chauvinistic arrangements with their clients).


258 See Wall Street's "Honor Code" on the first page of this Article.

259 The Commission will probably prefer to keep the law vague in this area, thereby maximizing its own flexibility to commence enforcement actions. Indeed, insider trading is only one of several areas in which the Commission has refused to promulgate a definition of proscribed conduct. See Guidelines for Release of Information by Issuers Whose Securities are in Registration, Securities Act Release No. 5,180, 36 Fed. Reg. 16506 (1971), [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶78,192, at 80,578 (Aug. 16, 1971) (concerning "gun jumping" by 1933 Act registrants). "It has been suggested that the Commission promulgate an all inclusive list of permissible and prohibited activities in this area. This is not feasible for the reason that determinations are based upon the particular facts of each case." Id. at 16,507, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 80,580. Sometimes this approach is appropriate because proscribed conduct is difficult to define and there is ample opportunity for ex ante consultation with the Commission. See id. ("[W]hile the statutory obligation always rests with the company and can never be shifted to the [Commission's] staff, the staff will be available for consultation concerning such
definition. Even if the Commission does promulgate regulations, Congress should consider defining that conduct for which it has already enacted both a private right of action and civil and criminal penalties.\textsuperscript{260} Indeed, as the Commission has begun more vigorously to enforce insider trading prohibitions over the last fifteen years, and as the penalties for such trading have been enhanced, the ABA's Task Force on the Regulation of Insider Trading\textsuperscript{261} and others have called on Congress to specify when trading on material, nonpublic information is illegal, so far without success.\textsuperscript{262}

In spite of its reluctance to act, Congress may be the best institution to make these determinations. Trading on inside and misappropriated information is a complex area of law that has engendered an outpouring of scholarship and disagreement.\textsuperscript{263} Much of the disagreement arises from a lack of consensus among scholars, regulators, and judges about the purpose to be served by regulation. The numerous possible purposes include protection of investors, prevention of unfair information asymmetries in trading transactions, promotion of confidence in the market, promotion of


\textsuperscript{261} Committee on Federal Regulation of Securities, American Bar Association, Report of the Task Force on Regulation of Insider Trading: Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934, 41 Bus. Law. 223, 225 (1985) [hereinafter ABA Report] ("The task force concludes that Congress can and should confront the basic policy question of what uses of informational advantage are to be forbidden, rather than leaving the law primarily to case-by-case development under present section 10(b) and rule 10b-5.").

\textsuperscript{262} See supra text accompanying note 202 (discussing Senator Alfonse D'Amato's criticism of Congress for failing to specify illegal trades). See also Joel Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L.J. 1083, 1090 (1985) (arguing that Congress should act to define insider trading); Louis Loss & Joel Seligman, Securities Regulation 3762 (3d ed. 1991) ("With full appreciation of the advantages of the common law's ad hoc approach, it still seems clear that the jurisprudence on trading while in possession of material nonpublic information has developed to the point where it cries out for the kind of philosophic consistency that only studied legislation can provide.").

\textsuperscript{263} See sources cited supra note 5.
disclosure, prevention of fraud, protection of proprietary information, enforcement of fiduciary duties, or some combination of the foregoing purposes. As Professor Louis Loss and Dean Joel Seligman have emphasized, a legislative determination “could address a fundamental question that the Supreme Court believed that it could not: whether a legislative approach ought to be limited to a fraud rubric?”\textsuperscript{264} A legislative determination, like a formal SEC rulemaking procedure, also offers the advantage of public participation to develop a consensus on the purposes of the regulation.\textsuperscript{265}

Moreover, Congress can define prohibited trading on material, nonpublic information in a systematic way, in the context of the federal securities laws as a whole, so the development of the law will not depend on the serendipity of what cases happen to arise after \textit{O’Hagan}. To be sure, Congress’s failure to define insider trading in 1988, even after the SEC finally endorsed a proposed definition, does not bode well for congressional action now, notwithstanding \textit{O’Hagan}.\textsuperscript{266} And yet there are any number of approaches Congress could take that would have the benefits of logical consistency and clarity not now found in this area of law.

\textsuperscript{264} Loss & Seligman, supra note 262, at 3763 (footnote omitted). The “alternative approach would involve simply prohibiting certain undesirable practices the same way that wash sales and certain short sales are prohibited.” Id.

\textsuperscript{265} Cf. Robert A. Anthony, Interpretive Rules, Policy Statements, Guidelines, Manuals, and the Like—Should Federal Agencies Use Them To Bind the Public?, 41 Duke L.J. 1311 (1992) (arguing against the use of informal guidelines as binding rules); Michael Asimow, On Pressing McNellis to the Limits: The Problem of Regulatory Costs, 57 Law & Contemp. Probs. 127 (1994) (arguing that notice and comment rulemaking produces better rules than a system without such a regime because of the public accountability it involves in the process); Donna M. Nagy, Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework, 83 Cornell L. Rev. (forthcoming 1998) (manuscript at 42-45, on file with The Virginia Law Review Association) (discussing the benefits of public participation when the SEC is required to change policies by promulgating rules in accordance with the Administrative Procedure Act, rather than through the use of the informal mechanism of no-action letters).

\textsuperscript{266} As discussed above, when Congress passed the 1984 Act, at the Commission’s urging it decided not to adopt a definition of insider trading. See supra text accompanying note 198. By 1988, however, when Congress again amended the securities laws, the Commission had changed its view (perhaps reluctantly), and had sent a proposed definition to Congress. SEC, Proposed Legislation: “The Insider Trading Act of 1987,” and Memorandum of Support, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶84,152, at 88,849 (Aug. 7, 1987).
For instance, Congress could establish a pre-*United States v. Chiarella* equality of access approach, even for outsiders, and then carve out exceptions, if necessary, for securities analysts and perhaps others who are perceived to benefit securities markets through their use of nonpublic information. This is the approach Joel Seligman advocated after *Dirks v. Securities and Exchange Commission* and *Chiarella*. His proposal suggested a general prohibition on trading while in possession of material, nonpublic information modeled on the *Securities and Exchange Commission v. Texas Gulf Sulphur Co.* approach, with certain provisions to "harmonize the new standard with other parts of the securities law." Those provisions included 1) an exception for potential acquirers prior to their acquisition of five percent of the target, necessary to parallel the Williams Act; 2) a legitimization of the "Chinese wall" defense for securities firms, whereby traders can continue to buy and sell the securities of issuers that have provided their underwriting departments with material, nonpublic information, so long as firm procedures are adequate to prevent information from leaking from the underwriters to the traders; 3) recognition that securities analysts could continue to search out immaterial, nonpublic information and make recommendations on the basis of that information; and 4) permission for "stock or options ex-

---

27 Seligman, supra note 262.
29 Seligman, supra note 262, at 1137-38. The Second Circuit in *Texas Gulf Sulphur* articulated a disclose or abstain rule with respect to trading on the basis of material, nonpublic information for anyone in possession of such information. 401 F.2d at 847-48. The court held that Rule 10b-5:

is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information . . . . Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed.

Id. at 848 (citations omitted).
30 Seligman, supra note 262, at 1138.
31 See The Securities Exchange Act of 1934 §§ 13(d), 14(d), 15 U.S.C. §§ 78m(d), 78n(d) (1994) (requiring disclosure by potential acquirers purchasing more than five percent of the beneficial ownership of any equity security).
change specialists, market-makers or floor traders to trade while in possession of material nonpublic information about trading activity on the floor of an exchange to the extent... permitted by section 11 of the Securities Exchange Act or Stock Exchange rules. 275

A somewhat narrower approach was suggested by Professor Victor Brudney: a ban on trading based on “unerosable informational advantages.” 276 Professor Brudney recognized that allocative efficiency goals are furthered by providing incentives for outsiders to search for relevant corporate and economic information; thus people ought to be able to benefit from the informational advantages that their searches provide by freely trading on such advantages. 277 Professor Brudney’s suggestion therefore does not follow a pure equality of access approach. Yet he argued that the law should “deny an informational advantage to those who seek to use otherwise nonpublic information which they are precluded by legal restrictions from disclosing to public investors,” 278 or which the public cannot lawfully acquire, notwithstanding diligent effort. 279

Professor Jill Fisch has suggested a still narrower approach, one that focuses on the duties of insiders to the market, particularly disclosure duties. 280 Her proposal concentrates on defining the insider class, since the harm to be prevented by insider trading regulation is “not only superior access to information but also the

275 Seligman, supra note 262, at 1138. Dean Seligman argues that the types of information analysts seek out and synthesize are generally bits and pieces of inside, corporate information, no one piece of which would be material, and that the important aspect of what an analyst does is interpret that information uniquely. See id. at 1120-23. He suggests, however, that while there should be no per se prohibition on analysts trading on such immaterial bits of information, if the information conveyed to analysts is material, such as concerning the mineral discoveries in Texas Gulf Sulphur, then the disclose or abstain rule should apply. See id. at 1122. Thus Dean Seligman argues that while a mandatory disclosure regime permits discretion to an issuer concerning the timing of disclosure of material information, “it is inconsistent to assert on the one hand that [a] mandatory corporate disclosure system generally requires disclosure of material, nonpublic information except when a corporation has a business justification for temporary nondisclosure, and on the other hand, that analysts should be encouraged to discover such nonpublic data” and be permitted to trade on it. Id.
276 Id. at 1138.
277 Brudney, supra note 5, at 376.
278 Id. at 341.
279 Id. at 355.
280 Id. at 355-56. See Loss & Seligman, supra note 262, at 3567-68 n.259 (describing Professor Brudney’s proposal).
281 See Fisch, supra note 120, at 238-39.
opportunity [by insiders] to manipulate the timing and quality of [market] disclosure" to capitalize on informational advantages.\textsuperscript{261} Professor Fisch's insiders would include "primary insiders" such as officers, directors, and ten percent stockholders, and "secondary insiders" such as lower-level employees and outsiders such as lawyers and investment bankers who have irregular access to material, nonpublic information.\textsuperscript{262} Both categories would be prohibited from trading or tipping while in possession of material, nonpublic information obtained by virtue of their status as an insider.\textsuperscript{263} In addition, Congress could look either to the detailed codes adopted in Great Britain and Germany\textsuperscript{264} or to the insider trading provisions of the Federal Securities Code, developed over ten years by the ALI under the guidance of Louis Loss, but never enacted into law.\textsuperscript{265} Professor Loss's Code set out a specific provision prohibiting insider trading, while recognizing that Section 10(b)'s broad antifraud analogue stood available as a backstop in the event a particular egregious case did not fall within the parameters of the insider trading section.\textsuperscript{266} Section 1603 of the Securities Code endorsed an abstain or disclose rule for insiders who know "fact[s]
of special significance" concerning the issuer or the security, while defining insiders broadly, to include any "person who, by virtue of his relationship or former relationship to the issuer, knows a fact of special significance about the issuer or the security in question that is not generally available." This formulation does not ground liability by reference to a fiduciary relationship or a relationship of trust and confidence with the issuer. Rather, any passage of material, inside information, coupled with any relationship with the issuer, suffices as a basis to impose a duty to abstain from trading. This provision thus avoids the complexities inherent in importing a separate body of law—that of fiduciary duty—into the insider trading prohibition. Moreover, this formulation more directly addresses concerns of inappropriate information asymmetries among investors than does the misappropriation theory. The latter does not reach outsiders' trading on inside information in the absence of a fiduciary relationship, nor under O'Hagan, does it reach outsiders who disclose to the principal their intention to trade. Although Section 1603 is animated by policy concerns closer to the equality of access theory, by imposing disclosure duties only on insiders, even as broadly defined, Section 1603 specifically disclaims complete equality of access among investors.

Congress may conclude, however, that Section 1603 is only a starting place. As Professor Loss recognized, a category of outsiders remains, who are not reached by Section 1603's definition. Congress may determine that:

It would be convenient to have a new category of 'quasi-insider' that would cover people like (i) judges' clerks who trade on information in unpublished opinions, (ii) Federal Reserve Bank employees who trade with knowledge of an imminent change in the margin rate, [and] (iii) printers of tender offer literature who buy the target company's stock . . . .

---

287 Id. § 1603(a).
288 Id. § 1603(b)(3).
289 See id. § 1603(a). Tippers are also treated as insiders for purposes of the prohibition, unless the Commission or a court would find that such treatment would be inequitable. Id. § 1603(b)(4).
290 Id. § 1603 cmt. d (citations omitted). This last category identified by Professor Loss would now be covered by Rule 14e-3. Supra notes 54-55 and accompanying text.
Professor Loss was concerned that this quasi-insider category would be difficult to define.\footnote{Fed. Sec. Code § 1603 cmt. a.} Perhaps, though, with Section 1603 as a starting point, and given the existence of Rule 14e-3\footnote{Supra notes 54-55 and accompanying text.} in the tender offer context, Congress could work to define the quasi-insider category with substantially more precision than the courts have used in defining the misappropriation theory. Indeed, the fact that this quasi-insider category is difficult to define with precision is a strong argument for Congress to undertake the task rather than leave it to the courts.\footnote{One approach to defining the quasi-insider category is to recognize that information is often conveyed for a specific business purpose. Liability in the quasi-insider category could require both possession of "fact[s] of special significance with respect to [an] issuer or [a] security," id. § 1603(a), and misuse of that information to trade or tip someone who trades. For instance, the law clerk is given the necessary information for the purpose of helping a court write an opinion, not for the purpose of enhancing her stock portfolio. Similarly, this is so with the Federal Reserve Bank employees and financial printers. In each instance, it is possible to identify the legitimate business purpose to be served by communication of the information and the illegitimate misuse of that information.}

One aspect of the ALI approach, which was echoed in 1985 by the ABA Task Force on Regulation of Insider Trading, is avoiding reliance on the law of fraud altogether, and instead simply prohibiting specific types of conduct.\footnote{ABA Report, supra note 261, at 253.} This approach recognizes that the misuse of informational advantages is an analytically different problem than fraud, and that regulating the former through an approach designed for the latter is problematic:

Because section 10(b) of the 1934 Act is an antifraud rather than an unfair-trading provision, any rulemaking initiative based on section 10(b), whether an expansion of present rule 10b-5 or a new rule aimed specifically at abuse of informational advantages like rule 14e-3, may be subject to some of the same problems that have accompanied development of the case law under rule 10b-5.

... If, as the task force believes, more specific guidance is required as to what conduct is forbidden, then a legislative definition based on legislative policy determinations is highly desirable, if not essential. ...
... Both proposals [set out by the Task Force] depart from the fraud-based framework of section 10(b) and the Chiarella and Dirks decisions, and instead directly regulate trading and tipping regardless of whether such conduct may be characterized as "fraud."293

The Task Force suggested two alternative statutes, one very specific and comprehensive, the other much simpler.294 Yet under both approaches the prohibited conduct was directly defined and regulated, rather than relying upon the analytic construct of fraud.295 Similarly, in response to those legislative proposals by the Task Force (introduced in the Senate in 1987), the SEC ultimately, if reluctantly, supported a statutory definition that departed from the fraud construct towards direct regulation of certain prohibited conduct.296

Finally, Congress could develop a statutory definition of the proscribed conduct based on a theory of property rights in information, and clearly define the relationship between the property rights in information and the trading transaction necessary to give rise to liability.297 Jonathan Macey has advocated this approach, defining the primary concern of prohibitions on trading on material, nonpublic information as the misuse of corporate property

293 Id. at 253.
294 Id. at 259-64.
295 See generally Loss & Seligman, supra note 262, at 3762-70 (discussing the ABA proposals and the SEC's response).
297 See Paul G. Mahoney, Technology, Property Rights in Information, and Securities Regulation, 75 Wash. U. L.Q. 815, 817 (1997) (asserting that "[s]ecurities law, then, should be understood as a law of property rights in information").
(information).\textsuperscript{300} Given this view of the harm to be prevented, Macey has argued that companies should be permitted to allow insiders to trade on proprietary company information.\textsuperscript{301}

Regardless of which proposal Congress adopts, it might consider bifurcating criminal liability from civil liability and SEC enforcement actions, in order to allow broader liability in the civil context while setting clear, very specific standards for the imposition of criminal sanctions. For example, Congress could empower the Commission to designate which categories of professionals and other fiduciaries could be held criminally liable for trading on misappropriated information and which categories would be subject only to civil liability to contemporaneous traders under Section 20A.\textsuperscript{302}

The above ideas are not meant to be exhaustive. Indeed, some commentators have suggested that insider trading should be legalized entirely.\textsuperscript{303} It may even be the case that as securities trading becomes more sophisticated, global, and instantaneous, any regulatory regime aimed at illegal informational advantages will become increasingly difficult to enforce in all but the most egregious cases. When an American can buy call options in Switzerland on securities traded in Japan, it may not be possible to detect unusual trading patterns that suggest illegal trading on material, nonpublic information. Perhaps in light of these realities, the expanded, real-time disclosure of corporate information that Professor Langevoort has suggested may be the most effective means to achieve the regulatory goals of investor protection and fundamental fairness.\textsuperscript{304} The point of this wide-ranging enumeration of possible legislative approaches is not to advocate any one idea. Rather, the point is to suggest that the proper institution to consider these and other suggestions and to make the necessary policy choices is Congress. Ab-

\textsuperscript{300} Macey, supra note 22, at 67.

\textsuperscript{301} Id. at 5. Alternatively Congress could determine that, as suggested by Larry Ribstein, the property right in information should be a question of state, not federal, law. See Larry E. Ribstein, Federalism and Insider Trading, 6 Sup. Ct. Econ. Rev. (forthcoming 1998) (on file with the Virginia Law Review Association).

\textsuperscript{302} See supra text accompanying notes 199-203.

\textsuperscript{303} See, e.g., Manne, supra note 5.

\textsuperscript{304} Donald C. Langevoort, Toward More Effective Risk Disclosure for Technology-Enhanced Investing, 75 Wash. U. L.Q. 753 (1997) (analyzing the problems of risk disclosure in public disclosure documents, and suggesting that, in an electronic disclosure environment, annual and quarterly filings should be replaced with a company file that is required to be relatively accurate and up-to-date on a real-time basis).
sent congressional action, the definition of illegal trading on pro-
scribed informational advantages will remain incomplete, unsystem-
atic, and analytically unsatisfying, particularly after O'Hagan.

CONCLUSION

We condemn the alleged conduct at the core of the O'Hagan
case—a lawyer’s use of confidential client information to trade in
the stock market. We also recognize that Congress or the Commiss-
ion may want to prohibit such conduct rather than leave the mat-
ter entirely to state fiduciary law. However, Congress and the
Commission will not be able to police our securities markets credi-
ibly without clearly specifying when it is and is not illegal to trade
on the basis of material, nonpublic information.

The misappropriation theory is appealing precisely because it
comports with our collective sense of moral approbation of people
breaching a position of trust for their personal and financial advan-
tage. Nonetheless, the securities laws were designed to protect in-
vestors, and the financial well being of an investor who trades with
a person in possession of material, nonpublic information has little
to do with whether the person breached a fiduciary duty to a third
party. Conditioning liability on the existence of a fiduciary rela-
tionship leaves many unexplained gaps in insider trading enfor-
cement, makes what remains of the enforcement scheme unpredic-
table and possibly inconsistent among circuit courts, and introduces
fiduciary duties having nothing to do with corporate law into the
heart of federal securities regulation. If the Commission believes
that Wall Street’s “Honor Code” should be predictable and under-
standable, it should promulgate new regulations. If Congress rec-
ognizes that much of this confusion stems from the way courts have
interpreted a statutory provision that does not even mention, much
less define, insider trading or misappropriation, Congress may also
recognize that it needs to amend Section 10(b) of the 1934 Act.