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I. INTRODUCTION

The Supreme Court has addressed the perplexing labyrinth of securities fraud since the enactment of the Securities and Exchange Acts of 1933 and 1934 (“Exchange Act”).4 In 1976, the president of a small brokerage firm induced customers to invest in fictitious escrow accounts, promising high yields to shareholders.5 The following year, majority shareholders of a Delaware lumber company instituted a merger based on what the minority shareholders deemed a fraudulent appraisal of the company’s assets.6 In 1980, a financial printer profited from his purchase and subsequent sale of shares in companies targeted for corporate
takeovers. Three years later, a corporate "outsider" was given information from someone within a life insurance and mutual fund organization to intentionally publicize the company's fraudulent practices. In each of these cases the Supreme Court was charged with interpreting the scope of §10(b) of the Exchange Act and Securities and Exchange Commission ("SEC") Rule 10b-5.

In United States v. O'Hagan, the Court attempted to reconcile the limitations it imposed on the scope of §10(b) and Rule 10b-5 in previous cases and the scope of the SEC's rulemaking authority in promulgating Rule 14e-3 pursuant to §14(e) of the Exchange Act. Specifically, the O'Hagan Court was asked to decide whether:

8 See Victor Brudney, Insiders, Outsiders, And Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 324, 339-53 (1979). The term "outsider" in the securities context refers to those persons who have no pre-existing fiduciary relationship to a corporation or its shareholders. Id. at 339. A corporate "insider", therefore, owes some duty to the corporation or its shareholders by way of a fiduciary relationship. Id. at 343.
10 In relevant part, §10(b) of the Exchange Act provides:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-
   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
11 Under its rulemaking authority the SEC set forth Rule 10b-5, which provides, in pertinent part:
   It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
   (a) To employ any device, scheme, or artifice to defraud, [or]
   (b) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
(1) the "misappropriation theory" of liability is consistent with the statutory reading of §10(b) and Rule 10b-5; and whether (2) the SEC improperly adopted Rule 14e-3(a) in relation to "tender offers" under its rulemaking authority particularly on the "misappropriation theory" and its inaugural application to §10(b) and Rule 10b-5. The governing statutory provision prescribing fraudulent trading in connection with a tender offer provides, in relevant part:

It shall be unlawful for any person . . . to engage in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer . . . The [SEC] shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

15 U.S.C. §78n(e) (1997). In 1980, Rule 14e-3(a) was promulgated pursuant to the SEC's rulemaking authority under §14(e). The Rule provides:

(a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the 'offering person'), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Exchange] Act for any other person who is in possession of material information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

(1) The offering person,
(2) The issuer of the securities sought or to be sought by such tender offer, or
(3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.


14 A tender offer is defined as: "A public announcement by a company or individual indicating that it will pay a price above the current market price for the shares 'tendered' of a company it wishes to acquire or take control of . . . Such purchase [sic] offer is used in an effort to go around the management of the second company, which is resisting acquisition." BLACK'S LAW DICTIONARY 1468 (6th ed. 1990); see also Piper v. Chris-Craft Indus., 430 U.S. 1, 24-37 (1977) (discussing the legislative history of the Williams Act and §14(e) with regard to tender offers, generally).
provided by §14(e).\textsuperscript{15}

Part II of this Note outlines the judicial development of the misappropriation theory and the objectives of the tender offer legislation.\textsuperscript{16} Part III presents the issues confronting the Supreme Court in \textit{O'Hagan} and explains the Court's conclusions.\textsuperscript{17} Part IV analyzes the Court's holding and assesses how its approval of the misappropriation theory and its interpretation of the SEC's ability to apply Rule 14e-3(a) will impact fraudulent activity in securities transactions.\textsuperscript{18}

II. BACKGROUND

A. \textit{The Development of the Misappropriation Theory}

The misappropriation theory imposes liability on a person who misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction.\textsuperscript{19} In contrast to the classical theory of liability under Rule 10b-5, the misappropriation theory does not require a breach of fiduciary duty to the buyer or seller of securities.\textsuperscript{20}

\textsuperscript{15} See \textit{supra} note 12 and accompanying text. The question presented to the Court is whether the SEC, through Rule 14e-3(a) may impose a duty to disclose nonpublic information in the absence of a fiduciary duty, which generally accompanies violations involving fraud or deceit. United States v. \textit{O'Hagan}, 117 S. Ct. 2199, 2214-15 (1997).

\textsuperscript{16} See \textit{infra} notes 19-40 and accompanying text.

\textsuperscript{17} See \textit{infra} notes 41-69 and accompanying text.

\textsuperscript{18} See \textit{infra} notes 70-108 and accompanying text. This Note questions the Court's reasoning in \textit{O'Hagan} at three levels. First, in its previous decisions, the Court was reluctant to expand the reach of Rule 10b-5 for fear of engrafting judicial gloss onto §10(b), a concern which the Court ignored when it adopted the misappropriation theory in \textit{O'Hagan}. Second, the Court adopted a version of the misappropriation theory not put forth by the SEC. Third, §14(e) permits the SEC to promulgate rules and regulations designed to prevent fraudulent activity in connection with tender offers, but the statute does not permit the SEC to create its own species of fraud to achieve that purpose.

\textsuperscript{19} \textit{O'Hagan}, 117 S. Ct. at 2207 ("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 purposes.").

\textsuperscript{20} \textit{Id.} ("The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to the trading party, but to the source of the information.").
The misappropriation theory first surfaced in Chief Justice Burger’s dissent in the seminal case *Chiarella v. United States.* Applying the classical theory of liability, the majority in *Chiarella* held that Rule 10b-5 could not apply to a corporate outsider who, owing no fiduciary duty to shareholders or buyers and sellers of securities, trades on nonpublic confidential information. The Court recognized that disclosure of material information prior to a securities transaction is compelled by Rule 10b-5 but only if there is “a fiduciary or other similar relation


22 See *Chiarella*, 445 U.S. at 232-33. A “mark up man” (printer) worked for a financial printing company in New York, handling corporate takeover bid announcements. *Id.* at 224. The printer received the documents from the corporations without the names of the companies set for takeover. *Id.* Prior to the corporations announcement of the takeover bids, the printer managed to identify the names of the target companies using information contained on the documents. *Id.* The printer used this information to purchase shares in the target companies without disclosing his knowledge. *Id.* He then sold the shares upon announcement of the takeover bids for a substantial profit. *Id.* In an opinion authored by Justice Powell, the Court focused on the relationship between the one using the confidential information and the shareholders of the company effected by the use of that information. Applying the classical theory of liability, the Court approved a prior SEC decision holding that a corporate insider could not use material nonpublic information “unless he has first disclosed all material inside information known to him.” *Id.* at 226-27 (approving *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961)). The Commission set forth the circumstances under which the duty to disclose information exists in the securities context. *In re Cady, Roberts*, 40 S.E.C. 907, 911 (1961). First, there must be a relationship allowing access to nonpublic information, intended only for corporate use and not for one’s personal benefit; and Second, it must radiate a degree of unfairness which can only accompany situations in which one party takes advantage of information he knows is unavailable to others. *Id.* at 912. The federal courts have addressed various circumstances in which such a duty is imposed. See, e.g., SEC v. Texas Gulph Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971) (finding a §10(b) violation where corporate insiders used nonpublic information for their own private use); Frigitemp Corp. v. Financial Dynamics Fund, Inc., 524 F.2d 275, 282 (2d Cir. 1975) (noting that the requirement of disclosing nonpublic information arises only when that party has a duty to disclose it). But see, e.g., General Time Corp. v. Talley Indus., 403 F.2d 159, 164 (2d Cir. 1968) (where it was held that there is no duty to reveal nonpublic information if the party is not an insider and owes no fiduciary duty to the offering corporation).
of trust and confidence between (the parties)" to a securities transaction.23

Chief Justice Burger argued that Rule 10b-5 was sufficiently broad to encompass the principle that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."24 The Court refused to consider the merits of the misappropriation theory because it was not presented to the jury at trial.25 While the Court did not reject the theory, it left open its consideration for another day.26

23 Chiarella, 445 U.S. at 230. The printer's use of the nonpublic information was not a fraud and thus not violative of Rule 10b-5 because he was not a corporate insider and therefore owed no duty to disclose prior to trading. Id. at 231 ("[A]pplication of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information . . . [but the printer's] use of that information was not a fraud under §10(b) unless he was subject to an affirmative duty to disclose it before trading.") (emphasis added); see also Aldave, supra note 13, at 104 (noting that the Chiarella Court's emphasis on fiduciary duty as a reflection of the fraud requirement in Rule 10b-5, which parallels common law fraud, requires a showing of a “misrepresentation of a material fact, scienter, reliance, causation, and damages”).

24 Chiarella, 445 U.S. at 239, 245 (Burger, C.J., dissenting). The brief by the Government premised the printer's conviction on an alternative theory which described a §10(b) violation as a breach of duty to the acquiring corporation occurring "when [the printer] acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation." Id. ("I would read §10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading."). Citing the majority's reliance on the Exchange Commission's Cady, Roberts decision, the Chief Justice would not have limited the duty to disclose to one with a fiduciary relationship, even though as a general rule one party to a business transaction owes no duty to another party. Id. at 239-40 ("[T]he rule should give way when an information advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.") (citing In re Cady Roberts & Co., 40 S.E.C. 907 (1961)).

25 Chiarella, 445 U.S. at 236-37 ("The jury was not instructed on the nature or elements of a duty owed by petitioner to anyone other than the sellers. Because we cannot affirm a criminal conviction on the basis of a theory not presented to the jury, we will not speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of §10(b)"). Justice Stevens, in his concurring opinion agreed that the Court should not have addressed the issue but acknowledged that if a corporate outsider had "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 'a fraud or a deceit' upon those companies 'in connection with the purchase or sale of any security.'"

26 Id. ("I think the Court wisely leaves the resolution of this issue for another day.").
Crucial to the development of the misappropriation theory was the Court's interpretation of the meaning of fraud and "fiduciary duty" in Rule 10b-5 cases.\(^{27}\) This issue was addressed in *Dirks v. SEC*\(^{28}\), where the Court held that a corporate tippee\(^{29}\) could not be guilty of §10(b) and Rule 10b-5 violations for failure to disclose material, nonpublic information, absent a breach of fiduciary duty by the corporate tipper.\(^{30}\) Central to the Court's finding was the absence of any fraudulent conduct by the tipper and the lack of any personally beneficial motive in disclosing the information to the tippee.\(^{31}\)

\(^{27}\) See *Dirks v. S.E.C.*, 463 U.S. 646 (1983) (addressing whether anyone who receives insider information has a duty to disclose under Rule 10b-5). To this point the duty to disclose arises only when the party owes a fiduciary obligation to shareholders and purchases securities based on material inside information. See *Aldave*, supra note 13, at 107-08 ("The distinction between the insider who sells and the insider who buys may well be a 'sorry' one, but it is a natural consequence of a theory which premises liability on a preexisting relationship between the trading parties.").


\(^{29}\) A tipper (an insider) is one who is afforded access to information within a corporation due to his employment or status with the corporation. Grumet v. Shearson/American Exp., Inc., 564 F.Supp. 336, 340 (D.N.J. 1983). A tippee (an outsider) is one who is the recipient of that information due to the actions of the tipper and who otherwise has no connection with the corporation. Ross v. Licht, 263 F.Supp. 395, 410 (S.D. N.Y. 1967).

\(^{30}\) *Dirks*, 463 U.S. at 660 ("[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."). Dirks (tippee) worked for a New York broker-dealer firm, advising investors on insurance company and other institutional securities. *Id.* at 648. In an effort to expose ongoing fraudulent activity, a corporate insider (tipper) for a life insurance and mutual funds securities company informed the tippee and encouraged him to advise investors and expose the fraud publicly. *Id.* at 649. The tippee notified investors, causing many of them to withdraw their holdings in the securities company. *Id.* The tippee owned no stock in the securities company and therefore owed no direct fiduciary duty to its shareholders. *Id.* at 665 ("[T]he tippee assumed an insider's duty to the shareholders not because he received inside information, but rather because it has been made available to them improperly."). The Court found that the tipper did not breach his fiduciary duty by disclosing nonpublic information because he "received no monetary or personal benefit for revealing [the securities company's] secrets, nor was [his] purpose to make a gift of valuable information to Dirks." *Id.* at 667 (premising a breach of fiduciary duty on the notion that the tipper received some pecuniary gain from his disclosure to a third party) (citing *In re*...
The Court’s interpretations of the scope §10(b) and Rule 10b-5 evidenced a general reluctance to expand the type of acts deemed manipulative and deceptive,\(^\text{32}\) while evidencing a willingness to expand the category of persons owing a fiduciary duty to trading parties.\(^\text{33}\) Thus, the Court left open the possibility that one who misappropriates nonpublic information, in breach of a fiduciary duty owed to the source of such information, violates §10(b).\(^\text{34}\)

**B. The Scope of the SEC’s Rulemaking Authority Under §14(e) of the Exchange Act**

§14(e) permits the SEC to promulgate a rule that is “reasonably designed to prevent acts and practices that are fraudulent.”\(^\text{35}\) Accordingly, the SEC established Rule 14e-3(a), which imposes a duty on traders in connection with a tender offer to either disclose nonpublic information relevant to the offer or to abstain from using such information.\(^\text{36}\)

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\(^{32}\) See, e.g., Chiarella v. United States, 445 U.S. 222, 234-35 (1980) (“[S]ection 10(b) is aptly described as a catchall provision, but what it must catch is fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.”).

\(^{33}\) Dirks, 463 U.S. at 655 n. 14 (“Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.”). But, Chiarella cautioned that the importance of requiring a fiduciary relationship was to prevent the injustice of “recognizing a general duty between all participants in market transactions to forgo actions based on material nonpublic information.” Chiarella, 445 U.S. at 233.

\(^{34}\) As noted, under the misappropriation theory, the fraudulent conduct is a party misappropriating confidential information entrusted to him for his own pecuniary gain. See Aldave, supra note 13, at 119 (rather than the parties to a securities transaction, the duty owed is to the source of the nonpublic information). The federal courts have recognized full disclosure as an absolute defense, since the legislative goal of maintaining informed markets would not be thwarted in that instance. Id. at 121. Consistent with the common law, the fraud is not complete under the misappropriation theory until some damage has been caused. United States v. Newman, 664 F.2d 12, 17 (2d Cir. 1981) (also holding that §10(b) violations are not limited to parties to a securities transaction).


\(^{36}\) United States v. O’Hagan, 117 S. Ct. 2199, 2215 (1997) (“Rule 14e-3(a) is a ‘disclose or abstain from trading’ requirement.”) (quoting Rules & Regulations Securities & Exchange Commission, 45 Fed. Reg. 60,410 (1980)) (to be codified at 17 C.F.R. § 240)). The underlying goal of §14(e) is to ensure that shareholders, in their consideration of tender offers, are not sabotaged by a lack of information. See Rondeau v. Mosinee Paper Corp., 422 U.S. 49, 58 (1975) (“The purpose of the Williams Act is to insure that public shareholders who are confronted by a cash tender offer for their stock will not be required
Prior to O'Hagan, the Supreme Court had not considered the validity of Rule 14e-3. The federal courts have interpreted Rule 14e-3(a) to impose liability on a person who fails to disclose nonpublic information in connection with a tender offer, without requiring a breach of a fiduciary duty. In the context of securities, fraudulent conduct requires a breach of a fiduciary duty. Thus, the Supreme Court's task in O'Hagan was to determine whether the SEC exceeded its rulemaking authority by excluding this requirement.

III. STATEMENT OF THE CASE

A. Facts

On October 4, 1988, James Herman O'Hagan, an attorney for Dorsey & Whitney, sold his shares of Pillsbury call options and common stock for a profit of more than $4.3 million. On that date, the stock of the Pillsbury Company was

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to respond without adequate information.


38 See, e.g., United States v. Chestman, 947 F.2d 551, 557 (2d Cir. 1991) (en banc) (holding that Rule 14e-3(a) "creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information"); accord SEC v. Peters, 978 F.2d 1162, 1165 (10th Cir. 1992); SEC v. Maio, 51 F.3d 623, 635 (7th Cir. 1995).

39 Chiarella v. United States, 445 U.S. 222, 228 (1980) ("One who fails to disclose material information prior to the consummation of a transaction commits fraud only... [when] the 'other party is entitled to know because of a fiduciary or other similar relation of trust or confidence.' ") (quoting In re Cady, Roberts, 40 S.E.C. 907, 912 (1961)).

40 O'Hagan, 117 S. Ct. at 2214 (stating the question posed on appeal- "Did the Commission... exceed its rulemaking authority under §14(e) when it adopted Rule 14e-3(a) without requiring a showing that the trading at issue entailed a breach of fiduciary duty?")

41 Id. at 2205 (O'Hagan was a partner at this Minneapolis, Minnesota law firm during the time the following events occurred.).

42 Id. By October of 1988, O'Hagan owned 2,500 unexpired Pillsbury call options and 5,000 shares of Pillsbury common stock after purchases beginning on August 18, 1988, and concluding in September, 1988. Id.
the subject of a tender offer made by Grand Metropolitan P.L.C. ("Grand Met"). Grand Met hired Dorsey & Whitney as local counsel to represent them in the tender offer. On September 9, 1988, Dorsey and Whitney withdrew as counsel for Grand Met, nearly one month before Grand Met announced its tender offer for the Pillsbury Company’s stock.

Although O’Hagan did not perform any duties in connection with Grand Met’s representation, the SEC began an investigation of O’Hagan’s transactions and issued a 57-count indictment alleging violations of securities laws and other criminal violations for attempting to conceal his conversion of unrelated client trusts.

B. Procedure

The SEC’s indictment charged O’Hagan with three counts of violating federal money laundering statutes; twenty counts of mail fraud; seventeen counts of

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43 Id. Grand Metropolitan P.L.C. is a London, England based corporation. Id.
44 Id. Not surprisingly, O’Hagan no longer worked for Dorsey & Whitney, nor was he a practicing attorney at the time this case was before the Court. Brief for Respondent, supra note 1, at 1. The Court also noted that O’Hagan was disbarred by the Supreme Court of Minnesota. Id. (referring to In re O’Hagan, 450 N.W.2d 571 (Minn. 1990)).
45 Id. According to Respondent’s brief, O’Hagan had completed most of his purchases before August 26, 1988, with the exception of his purchase of 5,000 shares of Pillsbury stock on September 20, 1988. Brief of Respondent, supra note 1, at 3.
46 O’Hagan, 117 S. Ct. at 2205. O’Hagan asserted in his brief that he had no way of knowing about the Grand Met tender offer. Brief of Respondent, supra note 1, at 5-6. O’Hagan bases this assertion on the Government’s failure to put forth any evidence regarding conversations he might have had with the partner in Dorsey & Whitney handling the Grand Met tender offer. Id. at 2-6.
47 O’Hagan, 117 S. Ct. at 2205. According to O’Hagan, the Government provided no evidence that he traded with nonpublic information. Id. at 2205 n.1. The investments, O’Hagan asserted, were based on solicitations from brokers who had learned of Grand Met’s interest in Pillsbury through news reports and investment orders from the broker’s other clients, indicating that something was brewing. Brief of Respondent, supra note 1, at 2.
48 O’Hagan, 117 S. Ct. at 2205 (listing O’Hagan’s counts under the indictment).
49 18 U.S.C. § 1956(a)(1)(B)(I) (1997). The money laundering and mail fraud charges drew scant attention from the Court and were not at issue on appeal, aside from the question of whether liability under these sections rested on the same criteria as the securities fraud and tender offer convictions. See O’Hagan, 117 S. Ct. at 2219-20.
securities fraud\(^5\); and seventeen counts of fraudulent trading in connection with a tender offer.\(^2\) O’Hagan was sentenced to forty-one months of imprisonment after a jury convicted him on all fifty-seven counts.\(^3\)

The Eighth Circuit reversed O’Hagan’s convictions.\(^4\) Following the Fourth Circuit’s reasoning, the Eighth Circuit rejected the application of the misappropriation theory to §10(b) and Rule 10b-5.\(^5\) The Court of Appeals also found that the SEC exceeded its rulemaking authority conferred by §14(e) by enacting Rule 14e-3(a), which prohibits trading while in possession of material, nonpublic information relating to tender offers without requiring a breach of fiduciary duty.\(^6\)


\(^{53}\) O’Hagan, 117 S. Ct. at 2205.


\(^{55}\) O’Hagan, 117 S. Ct. at 2206 (referring to the Eighth Circuit’s reliance on United States v. Bryan, 58 F.3d 933, 943-59 (4th Cir. 1995) and rejecting the misappropriation theory as well). The Eighth Circuit rejected the misappropriation theory for two reasons: (1) the theory does not require a showing of misrepresentation or nondisclosure; and (2) the theory circumvents the requirement that the alleged fraud be ‘in connection with the purchase or sale of any security.’ Id. at 2211 (citing O’Hagan, 92 F.3d. at 618 which quotes 15 U.S.C. §78j(b) (1997)). The first reason for the Eighth Circuit’s rejection of the theory is based on the meaning of the term misappropriation. O’Hagan, 92 F.3d. at 618. Section 10(b) liability requires a material misrepresentation or nondisclosure, not merely misappropriation of material, nonpublic information. Id. (“By its very definition then, it does not require either a material misrepresentation or nondisclosure.”).

The Eighth Circuit’s second reason for rejecting the misappropriation theory rests on the Supreme Court’s holdings in Chiarella, Dirks, and Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) (holding that a private plaintiff may not maintain an aiding and abetting suit under §10(b)). The Eighth Circuit interpreted those holdings to mean that “only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to §10(b) liability.” O’Hagan, 92 F.3d. at 618. Therefore, the Eighth Circuit explained, the imposition of duty owed to the source of nonpublic information does not follow from §10(b), since such an action is not ‘in connection with the purchase or sale of any security.’ Id. (quoting 15 U.S.C. §78j(b) (1997)).

\(^{56}\) O’Hagan, 92 F.3d. at 618. The Eighth Circuit departed from the reasoning of three federal circuits in holding that the SEC exceeded its rulemaking authority by not including the requirement of a breach of fiduciary duty. See, e.g., SEC v. Maio, 51 F.3d 623, 631 (7th Cir. 1995) (holding that Rule 14e-3(a) imposes a duty to disclose or refrain from trading on nonpublic information, irrespective of a breach of fiduciary duty); SEC v. Peters, 978 F.2d...
money laundering and mail fraud convictions rested on the same principles as the violations of the securities laws, the Eighth Circuit rejected those convictions as well.\textsuperscript{57}

Noting the conflict among the federal circuits with regard to the misappropriation theory, the Supreme Court granted writ of certiori to petitioners.\textsuperscript{58}

\textbf{C. Holding}

In a 6-3 decision authored by Justice Ginsberg, the majority approved the misappropriation theory and upheld the SEC's authority to regulate under Rule 14e-

\begin{itemize}
  \item \textsuperscript{57} United States v. O'Hagan, 117 S. Ct. 2199, 2206 (1997).
  \item \textsuperscript{58} United States v. O'Hagan, 117 S. Ct. 2199, 2206 (1997).
\end{itemize}
3(a).\textsuperscript{59} First, the Court found that the misappropriation theory\textsuperscript{60} fit within §10(b)'s requirement that the violative act constitute a "deceptive device or contrivance used in connection with the purchase or sale of securities."\textsuperscript{61} Second, the Court rejected the Eighth Circuit's interpretation of its holdings in Chiarella, Dirks, and Central Bank, stating that those precedents do not preclude application of the misappropriation theory to §10(b).\textsuperscript{62} The Court did not find that the duty arising under the

\begin{itemize}
\item \textsuperscript{59} \textit{Id.} at 2199. The Court remanded the case to the Eighth Circuit, not only to enter judgment consistent with the opinion, but also to consider O'Hagan's alternative theories for attacking his mail fraud convictions. \textit{Id.} at 2220. O'Hagan also preserved his rights to challenge, on remand, the Government's contention that the information used by O'Hagan for his trades was nonpublic. \textit{Id.} at 2205.
\item \textsuperscript{60} \textit{Id.} at 2208. The Court accepted the Government's definition of the misappropriation theory as one who "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 purposes, in breach of a duty owed to the source of the information." \textit{Id.} at 2207 (citing Brief for United States at 14, United States v. O'Hagan, 117 S. Ct. 2199 (1997) (No. 96-842)).
\item \textsuperscript{61} \textit{Id.} at 2208. The Court began its analysis of whether the misappropriation theory fit within the scope of §10(b) by addressing the meaning of "deceptive device or contrivance." \textit{Id.} A misappropriator satisfies the deceptive requirement because he converts information from one to which he owes a fiduciary duty for his own personal gain, while maintaining a facade of loyalty to the source of the information. \textit{Id.} However, once the misappropriator discloses the information entrusted to him as a fiduciary, there can be no deception and hence no violation. \textit{Id.} ("[B]ecause 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--... "). Cf. Santa Fe Indus. v. Green, 430 U.S. 462 (1977) (finding no deceptive or manipulative act on the part of majority shareholders owing a fiduciary duty to minority shareholders since all relevant facts were disclosed). Next, the Court was satisfied that the requirement of §10(b), that the deceptive use of the nonpublic information be "in connection with the purchase or sale of a security," was met "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." \textit{O'Hagan}, 117 S. Ct. at 2209. Thus, the misappropriator would not implicate §10(b) if he used the confidential information for reasons other than personal gain related to securities transactions. "The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions." \textit{Id.}
\item \textsuperscript{62} \textit{O'Hagan}, 117 S. Ct. at 2211-13. First, the Court stated that Chiarella merely declined to address the potential of §10(b) liability premised on the misappropriation theory because it was not presented to the jury. \textit{Id.} Chiarella merely held that §10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction." \textit{Id.} (quoting Chiarella v. United States, 445 U.S. 222, 230
\end{itemize}
statute could only exist with respect to parties to a securities transaction. Third, rejecting the Court of Appeals charge that the SEC exceeded its authority by creating its own definition of fraud in omitting the requirement of a breach of fiduciary duty under Rule 14e-3(a), the Court characterized §14(e)'s delegation of rulemaking authority as permissibly "definitional and prophylactic." Finally, the Court reversed the Eighth Circuit's reversal of the mail fraud convictions.

Justice Scalia filed an opinion, concurring in part, and dissenting with respect to the majority's reading of §10(b). Justice Thomas, joined by Chief Justice

(1980)). Next, the Court noted that Dirks did not preclude application of the misappropriation theory. O'Hagan, 117 S. Ct. at 2213 ("Dirks thus presents no suggestion that a person who gains nonpublic information through misappropriation in breach of a fiduciary duty escapes §10(b) liability, when, without alerting the source, he trades on the information.") (citing Dirks v. SEC, 463 U.S. 646 (1983)). Finally, the majority held that Central Bank did not limit the scope of §10(b) liability to deceptive conduct made by a fiduciary owing a duty to purchasers and sellers to a securities transaction. Id. at 2213 ("[W]e held that only actual purchasers or sellers of securities may maintain a private action under §10(b) and Rule 10b-5.") (quoting Central Bank v. First Interstate Bank, 511 U.S. 164 (1994)). The majority explained that, "[T]he purchaser/seller standing requirement for private actions under §10(b) and Rule 10b-5 is of no import in criminal prosecutions for willful violations of those provisions." Id. (quoting Holmes v. Securities Investor Protection Corp., 503 U.S. 258, 281 (1992) (O'Connor, J., concurring in part and concurring in judgment)).

63 O'Hagan, 117 S. Ct. at 2212. The Court rejected the Eighth Circuit's interpretation that Chiarella's holding limited the duty to disclose nonpublic, confidential information to parties to a securities transaction. Id. ("The Court did not hold in Chiarella that the only relationship prompting liability for trading on undisclosed information is the relationship between a corporation's insiders and shareholders.").

64 Id. at 2214 (focusing on the second sentence of §14(e) which authorizes the SEC to "prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative").

65 Id. at 2220. The Court dispensed with the Government's argument that the mail fraud charges were independent of the securities violations. Id. at 2219. The Court noted that the Eighth Circuit correctly recognized that the mail fraud convictions did not necessarily follow from the securities convictions. Id. (citing Carpenter v. United States, 484 U.S. 19, 24 (1987)). However, the Court of Appeals reversed the mail fraud convictions on the basis that the structure of the charges were indispensably linked to the securities charges. Id. Therefore, the Court did not "linger over this matter for [its] rulings on the securities fraud issues require[d] that [they] reverse the Court of Appeals judgment on the mail fraud counts as well." Id. at 2220. The Court also noted that O'Hagan's money laundering convictions were not raised on appeal and therefore remained intact. Id. at 2219 n.24.

66 Id. at 2220 (Scalia, J., concurring in part and dissenting in part). In strikingly limited breadth, Justice Scalia rejected the majority's analysis of §10(b) and Rule 10b-5. Id. Without so much as mentioning the misappropriation theory, Justice Scalia found that the
Rehnquist authored a lengthy dissenting opinion, rejecting the majority’s analysis of both §10(b) and §14(e). Justice Thomas concluded that the majority’s application of the misappropriation theory to §10(b) was “incoherent and inconsistent” and that the SEC failed to justify its promulgation of Rule 14e-3(a).

majority neglected to employ the principle of lenity which would limit an expansive reading of an ambiguous criminal statute such as §10(b). Id. (citing Reno v. Koray, 515 U.S. 50 (1995), and United States v. Bass, 404 U.S. 336 (1971)). On that basis, the Justice found that §10(b), “must be construed to require the manipulation or deception of a party to securities transaction.” Id. He found Justice Thomas’ reasoning for rejecting the majority’s analysis of §10(b), that the Government’s theory was not “coherent and consistent”, irrelevant. Id. The Government’s interpretation of a statute found to be ambiguous is not accorded deference under judicial review. Id. (citing Chevron v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984)). Thus, the issue was whether the Court’s interpretation of the statute is justified “regardless of the reasons the Government gave.” Id. Justice Scalia had no quarrel with the majority regarding Rule 14e-3(a) analysis. Id.

67 Id. at 2221-31 (Thomas, J., dissenting).

68 Id. at 2221 (“Because the Commission’s misappropriation theory fails to provide a coherent and consistent interpretation . . ., I dissent.”). The theory is incoherent and inconsistent to Justice Thomas for three reasons. First, it does not satisfy §10(b)’s requirement that the fraudulent act be used “in connection with the purchase or sale of any security.” Id. (citing 15 U.S.C. §78j(b) (1997)). Mr. O’Hagan’s breach of duty was to his employer, the source of the confidential information, but not to a purchaser or seller of securities. Second, the Government’s inconsistent argument that the “in connection with” requirement is met since the deceptive conduct and purchase of a sale or purchase of a security are connected because such information’s only use is for the purpose of buying or selling securities. Id. Here, Justice Thomas finds a discrepancy. The statute requires that the fraudulent act be consummated by the sale or purchase of a security, yet the theft of confidential information could be used for purposes other than the purchase or sale of securities. Id. at 2224. Under the majority’s theory, one who merely breaches a fiduciary duty may violate §10(b). Finally, Justice Thomas noted that the majority tries to rescue its incoherent analysis by substituting its own theory for the Government’s and by pointing to the broad policies underlying the Exchange Act. However, “regardless of the overarching purpose of the securities laws, it is not illegal to run afoul of the ‘purpose’ of a statute, only its letter.” Id. at 2225.

69 Id. at 2221 (“[W]hile §14(e) does allow regulations prohibiting nonfraudulent acts, neither the majority nor the Commission identifies any relevant underlying fraud against which Rule 14e-3(a) reasonably provides prophylaxis.”). Justice Thomas agrees with the majority that Rule 14e-3(a) is a codification of Chief Justice Burger’s dissenting opinion in Chiarella, only that it is applied in the tender offer context. Id. at 2228. However, Justice Thomas does not agree that the SEC’s authority under §14(e) permits them to “prohibit trading in connection with any nondisclosure, regardless of the presence of a pre-existing duty to disclose.” Id. The SEC may only regulate nondeceptive acts if such regulations are reasonably designed to prevent manipulative or deceptive acts as such acts are defined in the securities context. Id. (“Insofar as the Rule 14e-3(a) purports to ‘define’ acts and practices

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IV. ANALYSIS

The Supreme Court in *O’Hagan* did little to mitigate the enigmatic state of securities regulation. First, the Court engrafted further judicial gloss on the already frayed §10(b) and Rule 10b-5. Second, the Court perpetuated the uncertainty of §10(b) liability by proclaiming that the version of the misappropriation theory it was embracing did not impose an absolute duty on any party in possession of nonpublic information, while simultaneously holding that such a duty was not limited to parties to a securities transaction. Finally, even assuming, that ‘are fraudulent,’ it must be measured against our precedents interpreting the scope of fraud.” (citing *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 11, n.11 (1985)).

Furthermore, since the SEC cannot “coherently” assert that Mr. O’Hagan’s misappropriation (deceptive act) was in connection to the sale or purchase of securities, it cannot accomplish the same thing by stating that the misappropriation was in connection with a tender offer. *Id.* at 2229 (“[T]he Commission may not seek to prevent indirectly conduct which it could not, under its current theory (misappropriation theory), prohibit directly.”).

70 Elizabeth S. Strong, *Supreme Court Endorses Misappropriation Theory*, N.Y.L.J., July 17, 1997, at 1 (“The endorsement of liability for fiduciaries who misappropriate nonpublic information and use it to trade for personal profit leaves the door open for criminal prosecutions, and may well foster new theories of liability. When and against whom the government will be able to enforce the misappropriation theory is now open for discussion.”). But see, David Cowan Bayne, *Insider Trading and the Misappropriation Theory: The Awakening*, 1995, 30 Loy. L.A. L. Rev. 487, 530 (1997) (“Do not forget that it was the chaos in the law that spawned the Theory in the first place.”). However, the misappropriation theory may not have the curing effect the Court had hoped. See Lawrence Rosenbloom, *Note, Is it Inside or Out?- A Proposal to Clarify the Misappropriation Theory of Unlawful Trading*, 18 Cardozo L. Rev. 867, 899 (1996) (noting that a legitimate argument supports the fact that the theory is “amorphous and has the potential to have as many permutations as there are fiduciary ‘or similar’ relationships.”).

71 Harvey L. Pitt & Karl A. Groskaufmanis, *The Supreme Court Upheld the Misappropriation Theory, But How Far the SEC Will Take the Ruling is Anything But Clear*, Nat’l L.J. Aug. 4, 1997, at B4 (“In a sweeping decision reminiscent of the Supreme Court’s expansive interpretations of the federal securities laws in the 1960s and early 1970’s . . . . Abandoning [its] literalist reading of the federal securities laws, the majority ruled that the misappropriation theory was well within the broad remedial purposes of the Exchange Act.”).

*O’Hagan*, 117 S. Ct. at 2208 n.6 (“The Government does not propose that we adopt a misappropriation theory [that would] impose ‘an absolute duty to disclose that information or to refrain from trading’ ”) (quoting Chief Justice Burger’s dissent in *Chiarella v. United States*, 455 U.S. 222, 240 (1980)). But, *Chiarella* held that the mere possession of confidential nonpublic information without a breach of a fiduciary duty by a person in whom “the sellers had placed their trust and confidence” could not invoke §10(b) liability. 455 U.S. at 232. The misappropriation theory adopted by the *O’Hagan* Court imposes liability...
arguendo, that the Court was correct in presuming that Rule 14e-3(a) was not the equivalent of the SEC designing its own definition of fraud, it is hard to see how the absence of a requirement of a breach of fiduciary duty accomplishes the legislative purposes of §14(e).

A. The Nebulous Scope of The Misappropriation Theory

In adopting the misappropriation theory in O'Hagan, the majority insisted that the theory fell neatly within the precedent interpreting the scope of §10(b). While Justice Powell effectively dodged the misappropriation issue in Chiarella, he left open the question whether the duty giving rise to the disclosure requirement under §10(b) could stem from a relationship to parties other than those dealing in a securities transaction. Yet, over a decade has passed since the Chiarella decision and Congress has still done nothing to answer Justice Powell's invitation to amend the statute and enable the SEC to regulate the misappropriation of confidential information to situations other than 'in connection with the purchase or sale of any security.'

The SEC's goal in promulgating Rule 14e-3(a) is to eliminate "'unfair disparities in market information and market disruption.' " Rules & Regulations Securities & Exchange Commission, 45 Fed. Reg. 60,410, 60,412 (1980) (to be codified at 17 C.F.R. § 240). The Rule does not accomplish the directive of §14(e) of prescribing "means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative," because the Rule does not require a breach of fiduciary duty, which is inherent in finding and preventing fraud. O'Hagan, 117 S. Ct. at 2230 (Thomas, J., dissenting) (quoting 15 U.S.C. §78n(e) (1997)). Approval of the Rule by the Court allows the SEC to create 'market disruption' rather than preventing it, because it will punish market players for acting on market rumors or leaks, making it a regulation that is too broad to be enforceable. See Pitt & Groskaufmanis, supra note 71, at B4. ("Despite everyone's best efforts, putative tender offers often become the source of market rumors. Trading on the basis of such rumors is not proscribed. O'Hagan, however, adds to the risks.").

The result of Congress' inaction was a split among the Federal Circuits, leading to O'Hagan. The Circuits were split three to two in favor of the misappropriation theory with the Second, Seventh, and Ninth Circuits in favor of the theory. See United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir. 1983), cert. denied, 464 U.S. 863 (1983); United States v. Chestman, 947 F.2d 551 (2d Cir. 1991) (en

*Chiarella*, 445 U.S. at 226 (“[W]hen Rule 10b-5 was promulgated in 1942, the SEC did not discuss the possibility that failure to provide information might run afoul of §10(b).”). Although §10(b) confers substantial latitude to the SEC, “[T]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law . . .” and the “Rule advanced by the Commission . . . cannot exceed the power granted to the Commission by Congress under §10(b).” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 213-14 (1976). *See* John R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1107-08 (1996) (an excellent overview of “[t]he Dubious History of Rule 10b-5”). According to Beeson, the SEC “never anticipated that the rule would be a ‘catch-all’ provision for fraud.” *Id.*; *see also* Joseph J. Humke, Comment, *The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)*, 80 MARQ. L. REV. 819, 830 (1997) (referring to Justice Holmes’ comment that the judicial interpretations of statutes should only concern “what Congress said, and not what it meant”) (quoting Oliver Wendel Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 419 (1899)).

*See* Aldave, *supra* note 13, at 121 (advocating adoption of the misappropriation theory to rid the confusion associated with interpreting §10(b)). “One of the virtues of the misappropriation theory is that it eliminates many of the fictions and anomalies that are associated with the *Chiarella-Dirks* reasoning.” *Id.* This position is none other than wrong, for the O’Hagan Court expressly accepted the reasoning in *Chiarella* and *Dirks*, and merely found that their holdings did not forego the applicability of the misappropriation theory. *See* O’Hagan, 117 S. Ct. at 2212 (“*Chiarella* thus expressly left open the misappropriation theory before us today . . . *Dirks*, too left room for application of the misappropriation theory in cases like the one we confront.”). What is very much unclear is the supposed curing effect the theory will have on the uncertainties of securities regulation. *See supra* note 70 and accompanying text; *see also* Michael P. Kenny & Teresa D. Thebaut, *Misguided Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(B)*, 59 ALB. L. REV. 139 (1995) (emphasizing that the essence of statutory interpretation involves drawing a line with regard to a statute’s scope). The Supreme Court has consistently determined the scope of §10(b) “by reviewing the statute and its relatively
theory "permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction." By broadening the scope of §10(b), the majority ignored decades of precedent warning against applying an interpretation of the Exchange Act beyond its textual meaning. Instead of creating a regulation that attempts to fit a person's acts within §10(b) on an ad hoc basis, the SEC should simply promulgate a rule defining what insider trading is, thereby making it clear who may violate the statute.

sparse legislative history." Id. at 142 ("Based on this thoughtful line of cases, which included vigorous debate among the justices, the Court has held that section 10(b) is an 'antifraud' statute designed to prescribe fraud in the purchase or sale of a security.").


The problem with the misappropriation theory is that it imposes liability "based on the breach of duty owed to the source of the information, not to the other party to the securities transaction, thus ignoring the "in connection with" requirement. Timothy J. Horman, Comment, In Defense of the United States v. Bryan: Why the Misappropriation Theory is Indefensible, 64 FORDHAM L. REV. 2455, 2498 (1996) (endorsing the Fourth Circuit's reading of the "in connection with" requirement as reaching 'only deception of persons with some connection to, or some interest or stake in, an actual or proposed purchase or sale of securities.' ") (quoting United States v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995)).

80 See Humke, supra note 77, at 819-30 (noting that "[f]or almost two decades, the Supreme Court has repeatedly warned against reading the 1934 Exchange Act 'more broadly than its language and . . . statutory scheme reasonably permit' "). (citing Chiarella v. United States, 445 U.S. 222, 234 (1980)) (quoting Touche Ross & Co. v. Redington, 442 U.S. 560, 578 (1979)); accord Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976) (where the Court refused to "add a gloss to the operative language of the statute quite different from its commonly accepted meaning"); Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977) (where despite valid policy concerns, the Court relied on the language of the statute which gave "no indication that Congress meant to prohibit any conduct not involving manipulation or deception.").

81 The Exchange Act defines directors and officers of a corporation who clearly owe fiduciary duties as insiders, but the Chiarella Court was forced to bring employees within the definition using its own language as those having "a similar relation of trust and confidence'. See Beeson, supra note 77, at 1145 (quoting Chiarella, 445 U.S. at 228). Instead of leaving the onus on the courts, the SEC, with little trouble could include a definition of an insider, which would include attorneys, bankers, accountants, and other consultants who are typically trusted with confidential information by virtue of their position. Id. at 1146. This would have the effect of making it easier to identify which
However, undeterred by the language of §10(b), the Court extended the disclosure obligation to the source of the information obtained by the misappropriator, but did not go so far as to hold that any misappropriator of nonpublic information has an absolute duty to disclose such information. To justify this “limited” extension of the Rule, the majority relied on the close nexus between O’Hagan’s embezzlement of information and its use in connection with a securities transaction as compared with the embezzlement of money. While the actions performed by which persons constitute fraud in connection with a securities transaction where, as in O’Hagan, the “traditional corporate fiduciary relationship is absent.” Id. at 1143; see also Jeffrey J. Hatch, Note, Logical Inconsistencies in the SEC’s Enforcement of Insider Trading: Guidelines for a Definition, 44 WASH. & LEE L. REV. 935, 953 (1987) (“The SEC could amend rule 10b-5 to include an exact definition of insider trading. . . . [A]n insider trading definition would not present an undue burden on the SEC’s enforcement of insider trading. [Ideally] Congress could alleviate the need for increased litigation by offering examples of the types of activities that the definition covers and by providing examples of exempted transactions.”).

O’Hagan, 117 S. Ct. at 2208 n.6 (1997) (noting that the Government was not asking the Court to adopt Chief Justice Burger’s broad reading of §10(b)); see also Chiarella v. United States, 445 U.S. 222, 240 (Burger, J., dissenting) (“By their terms, these provisions reach any person engaged in any fraudulent scheme.”). Justice Burger’s reading of both the statute and the rule goes too far. See Aldave, supra note 13, at 115. “There is virtually no authority for the view that a defendant who has unlawfully obtained information, or improperly converted information to his own use, is subject to an absolute duty to disclose it to those with whom he transacts business.” Id.

O’Hagan, 117 S. Ct. at 2209 (discussing the Governments argument that the acquisition of money through deceptive means would not invoke the misappropriation theory, but that the acquisition of nonpublic information would). The Government’s comparison is as follows:

THE MISAPPROPRIATION THEORY IS LIMITED TO FRAUDULENT MEANS OF PROFITING ON CONFIDENTIAL INFORMATION THROUGH THE SALE OR PURCHASE OF SECURITIES, NOT ANY FORM OF FRAUD INVOLVING CONFIDENTIAL INFORMATION

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<th>Embezzlement of Money</th>
<th>Embezzlement of Nonpublic Information</th>
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<td>(1) The fraudulent act is consummated at the point the actor embezzles the money;</td>
<td>(1) The fraudulent act is consummated at the point the actor uses the information to trade in securities.</td>
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<tr>
<td>(2) Money can be used to purchase things other than securities;</td>
<td>(2) Confidential information has no value apart from its use in connection with securities transactions</td>
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<td>(3) Therefore the theory does not apply.</td>
<td>(3) Therefore, the misappropriation applies.</td>
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former derives its value only from its use associated with securities, the latter can be used in many other ways.\textsuperscript{84}

This comparison is questionable because its validity is based on the premise that the only value derived from nonpublic information is in connection with securities transactions.\textsuperscript{85} As Justice Thomas points out in his dissent, if the "in connection with" test is "whether the fraudulent act is necessarily tied to a securities transaction, then the misappropriation of confidential information used to trade no more violates §10(b) than does the misappropriation of funds used to trade."\textsuperscript{86} The

\textsuperscript{84} Id. The majority was content that the misappropriation theory satisfied the ‘in connection with requirement’ "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.” Id. In contrast, the embezzlement of money would not fall within the theory because “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.” Id.

\textsuperscript{85} Id. at 2210 (“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.”). This was a contentious point between the dissent and the majority, resulting in bantering, back and forth, over what uses confidential information may be applied toward. The dissent: “O’Hagan could have done any number of things with the information: He could have sold it to a newspaper for publication; he could have given or sold the information to Pillsbury itself; or he could even have kept the information and used it solely for his personal amusement, perhaps in a fantasy stock trading game.” Id. at 2223 (Thomas, J., dissenting). The majority: “It is hardly remarkable that a rule suitably applied to the fraudulent uses off certain kinds of information would be stretched beyond reason were it applied to the fraudulent use of money . . . [T]he dissent’s evident struggle to invent other uses to which O’Hagan plausibly might have put the nonpublic information is telling.” Id. at 2210 n.8.

\textsuperscript{86} Id. at 2224 (Thomas, J., dissenting). It should not matter whether or not the misappropriator actually uses the information to purchase securities because in both the case of embezzling money and the case of embezzling information, the fraudulent actor could use the material for purposes other than the purchase of securities. Id. at 2223. See Mitchell, supra note 79, at 830 (noting that “it is not at all clear what misappropriation of information has to do with fraud, especially if the person from whom the information was misappropriated was not trading in the securities to which it relates”). The Government’s argument clearly contradicts the holding in Dirks, where the Court found that the tippee would have been liable if the tipper had breached a fiduciary duty. See Dirks v. S.E.C., 463 U.S. 646, 664-65 (1983). But, under the misappropriation theory, the tipper could pass the information to a tippee in breach of a fiduciary duty. The misappropriation occurred when the tipper passed the information, but before the tippee used the information to trade in securities. Thus, the tipper would not be liable under the misappropriation theory.
effect of the Court's rational is to impose an absolute duty on those who have misappropriated nonpublic information, regardless of whether it is in connection with a securities transaction.\(^8\) Thus, the Court's adoption of the misappropriation theory is a carefully cloaked engraftment to §10(b).\(^8\)

**B. The Court's Substitution of Ordinarily for the Government's Theory of Only**

The *O'Hagan* Court partially recognized the flaw in the Government's embezzlement comparison.\(^8\) To rescue the analytical deficiency of the Government's argument that misappropriated nonpublic information derives its *only* value in connection with a securities transaction, the majority replaced the term *only* with *ordinarily*.\(^9\) Aside from the dubious act of the Court substituting its own theory for the one presented by the SEC,\(^9\) the term will leave future traders wondering...

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\(^8\) The majority's holding also contravenes *Chiarella* by requiring that O'Hagan disclose the information upon his "mere possession of nonpublic market information." *Chiarella v. United States*, 445 U.S. 222, 225 (1980). The duty to disclose does not arise unless O'Hagan had a relationship with the parties to a transaction. See Shawn J. Lindquist, Note, *United States v. O'Hagan: The Eighth Circuit Throws the Second Strike to the Misappropriation Theory of Rule 10B-5 Liability*, 1997 B.Y.U. L. Rev. 197, 221 (1997) (The Supreme Court in *Chiarella* rejected the notion that "a complete stranger to the market participants and deals with them only through impersonal market transactions, [can be] liable under section 10(b) . . ."). This means that the defendant in *Chiarella*, who was not found liable under § 10(b), would be found liable under the misappropriation theory even though he owed no duty to the parties connected with a securities transaction, simply because he possessed information. See Beeson, *supra* note 77, at 1147.

\(^8\) See *Santa Fe Indus. v. Green*, 430 U.S. 462, 472 (1979) (rejecting the Second Circuit Court of Appeals' attempt to "add a gloss to the operative language of the statute quite different from its commonly accepted meaning") (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976)) (internal quotations omitted); *but see United States v. O'Hagan*, 117 S. Ct. 2199, 2220 (1997) (Scalia, J., concurring in part and dissenting in part) (describing Rule 10b-5 as "no less ambiguous than the statute" (§10(b)).

\(^9\) *O'Hagan*, 117 S. Ct. at 2210 ("The dissent does catch the Government in overstatement.").

\(^9\) Id. ("Substitute 'ordinary' for 'only' and the Government is on the mark."). Justice Thomas notes that by substituting ordinarily for only, the majority vitiates its entire justification for relying upon the Government's proffered theory which satisfies the 'in connection with' requirement because of the close nexus between the breach of duty and the use of the information to purchase securities. *Id.* at 2224 (Thomas, J., dissenting) ("one is left to wonder how we could possibly rely on a post hoc rationalization invented by this Court and never presented by the Commission for our consideration").

\(^9\) Id. ("It is a fundamental proposition of law that this Court 'may not supply a reasoned basis for the agency's action that the agency itself has not given.'") (quoting *Motor Vehicle Mfrs. Ass'n of United States v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).
what type of information is *ordinarily* associated with securities transactions.\(^{92}\)

The majority attempts to save itself by saturating its opinion with fragments of legislative intent evidencing a concern for preserving honest and informed securities markets.\(^{93}\) It is obvious that one who misappropriates nonpublic information obtains an advantage in the market, creating a disadvantage to other traders which “cannot be overcome with research or skill.”\(^{94}\) However, the Court’s requirement that the misappropriation theory target information that ordinarily derives its value through securities transactions is a tenuous hitch to §10(b)’s textual requirement that the deceptive use of information be “in connection with the sale or purchase of a security.”\(^{95}\) Rather than imposing a judicially molded, all encompassing rule, regulating all types of fraud in the “corporate universe”,\(^{96}\) the Court should allow state corporate law to serve as the means for punishing deceptive acts unconnected with securities transactions.\(^{97}\) Moreover, a clear definition of insider trading will

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\(^{92}\) *Id.* at 2225 (“persons subject to this new theory, such as respondent here, surely could not comply with the new theory, because until today, the theory has never existed”); see also Pitt & Groskaufmanis, *supra* note 71, at B4 (“The lasting impact of O’Hagan will be in the difficult gray areas in which, to date, the SEC’s Enforcement Division has tempered its desire to press enforcement actions.”). “Ordinarily” the SEC does not involve itself in situations where a “company’s spokesperson disseminates key information on a selective basis” to market analysts or the financial press, where clearly this “segment of the market place is afforded an opportunity to trade directly on the basis of material, nonpublic information.” *Id.*. The theory the majority adopted in *O’Hagan* does not make clear whether this type of selective disclosure creates a duty upon the recipients to refrain from trading.\(^{93}\) *O’Hagan*, 117 S. Ct. at 2210 (“The theory is also well-tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.”).\(^{94}\) *Id.* (“An investor’s informational disadvantage vis-a-vis a misappropriator with material, nonpublic information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill.”).\(^{95}\) *See* Humke, *supra* note 77, at 811 (stating simply that “the misappropriation theory does not meet the in connection with requirement”).\(^{96}\) Santa Fe Indus. v. Green, 430 U.S. 462, 480 (1977) (“There may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint. But those standards should not be supplied by judicial extension of § 10(b) and Rule 10b-5 to ‘cover the corporate universe.’”) (quoting William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700 (1974)).\(^{97}\) Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties Into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1258 (1995) (noting that the “first place one must look to determine the powers of corporate directors is in the relevant State’s corporation law.”). Indeed, the Supreme Court has consistently expressed concerns that expanding the depth of fiduciary duties owed to corporations would encroach upon state corporate laws. *Santa Fe Indus.*, 430 U.S. at 478-79 (refusing to extend Rule 10b-5 private
help remedy the gap left open by §10(b), but it is Congress and not the Court that should be the one to fill it.\textsuperscript{98}

C. Redefining The Meaning of Fraud

The Supreme Court's finding that Rule 14e-3(a)'s omission of a breach of fiduciary duty requirement may be a reasonable means of preventing fraudulent conduct but it is also the equivalent of permitting the SEC to define a new species of fraud.\textsuperscript{99} Section 14(e) allows the SEC to "define and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent."\textsuperscript{100} In the context of securities regulations, however, a deceptive act is the failure to disclose when there is "a duty to disclose arising from a relationship of trust and confidence."\textsuperscript{101} The actions against fiduciary's who have not acted deceptively, the Court noted that to do so "would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation"). The misappropriation theory imposes a duty to persons that Congress never envisioned would fall under federal law. Bainbridge, \textit{supra} at 1258 ("the legislative history of the Exchange Act demonstrates that Congress intended to leave regulation of corporate governance to the states") (citing \textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907, 910 (1961)).

\textsuperscript{98} See \textit{Ernst & Ernst v. Hochfelder}, 425 U.S. 185, 214 (1976) ("When a statute speaks so specifically . . . and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute . . . ."). No doubt Mr. O'Hagan should be punished for his actions, but "the desire to produce liability in circumstances of these cases has led to an inadequate and unworkable doctrine." Beeson, \textit{supra} note 77, at 1142. The problem facing the Court in \textit{O'Hagan} was the same problem that caused the split among the Federal Circuits: Mr. O'Hagan's actions gave him an impermissible advantage obtained by a deceptive act, which did not fall within the plain text of Rule 10b-5. To remedy this anomalous situation, the text should be amended, not the way courts interpret it. See \textit{Central Bank v. First Interstate Bank}, 511 U.S. 164, 175 (1994) ("Our consideration of statutory duties, especially in cases interpreting §10(b), establishes that the statutory text controls the definition of conduct covered by §10(b).").

\textsuperscript{99} \textit{O'Hagan}, 117 S. Ct. at 2227 (Thomas, J., dissenting) (agreeing with the Eighth Circuit's finding that Rule 10b-5 "exceeds the scope of the Commission's authority to define such acts and practices as 'are fraudulent'"). Tortious fraud, misrepresentation, or deceit involves the following factors: (1) a false representation, (2) knowledge that the representation is false ('scienter'), (3) intent to induce action or inaction on the part of the plaintiff, (4) justifiable reliance by the plaintiff; and (5) damage. \textit{William L. Prosser, The Law of Torts} §105, 685-86 (4th ed. 1971).

\textsuperscript{100} 15 U.S.C. §78n(e) (1997). \textit{See supra} note 12 (providing statutory text of §14(e) and Rule 14e-3(a)).

\textsuperscript{101} \textit{Chiarella v. United States}, 445 U.S. 222, 230 (1980) (holding that §10(b) liability must be "premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"). Thus, without the existence of a fiduciary relationship
Court neglects this point by emphasizing that the SEC was granted rulemaking authority to carry-out a prophylactic measure, i.e. to prevent fraudulent conduct through “reasonably designed” methods. 102

However, Rule 14e-3(a) exceeds this statutory mandate by not requiring a breach of fiduciary duty. 103 As both statutes are part of the same legislative scheme, the Supreme Court has relied on §10(b) to interpret §14(e). 104 Since the duty to disclose under §10(b) arises out of a fiduciary obligation, §14(e) also requires a breach of a fiduciary obligation. 105 Yet, Rule 14e-3(a) is barren, requiring simply that all parties must “disclose or abstain from trading” on material, nonpublic information in the tender offer context. 106 While, Rule 14e-3(a) helps to achieve the

and a subsequent failure to disclose there can be no deception. 107 O'Hagan, 117 S. Ct. at 2217 (“[A] prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited.”). 108 Id. at 2228 (Thomas, J., dissenting) (“Rule 14e-3(a) does not prohibit merely trading in connection with fraudulent nondisclosure, but rather it prohibits trading in connection with any nondisclosure, regardless of the presence of a pre-existing duty.”).

104 Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 8 (1985) (after rejecting the petitioner’s argument that §10(b)’s requirement of a manipulative or fraudulent act should not be applied to §14(e), the Court noted that “it is a ‘familiar principle of statutory construction that words grouped in a list should be given related meaning.’ ”) (quoting Securities Indus. Ass’n v. Board of Governors, 468 U.S. 207, 218 (1984)).

105 United States v. O’Hagan, 92 F.3d 612, 625 (8th Cir. 1996), rev’d, 117 S. Ct. 2199 (1997) (“Reading Schreiber and Chiarella together [while] interpreting §14(e) and §10(b) respectively leads to the conclusion that ‘fraudulent’ under §14(e) includes the breach of a fiduciary obligation.”). The Supreme Court found this interpretation irrelevant since Rule 14e-3(a) is not an attempt by the SEC to define fraud as requiring something less than a breach of a fiduciary or similar duty, but merely a means by which the SEC “may prohibit acts, not themselves fraudulent . . . [but which are] reasonably designed to prevent” acts that are fraudulent. O’Hagan, 117 S. Ct. at 2217. However, the Eighth Circuit is correct when it states that the SEC may not define the meaning of fraud under §14(e). Voves, supra note 37, at 1035 (“Interpreting s 14(e) to allow the SEC to either define s 14(e) fraud itself or prohibit insider trading in the absence of fraud infringes on the independent statutory meaning of § 14(e)’s anti-fraud provisions, and thus conflicts directly with the Supreme Court’s holding in Schreiber.”). The fact is, Rule 14e-3(a) indirectly allows the SEC to define fraud because it has the effect of “placing a duty on all market participants to disclose inside tender offer information before trading on the basis of such information.” 109 Id.

106 The majority justified the disclose or refrain from trading requirement of Rule 14e-3(a) as a reasonable means of preventing fraud by noting that the SEC is entitled to deference in its interpretation of §14(e). O’Hagan, 117 S. Ct. at 2217-18 (“[W]e must accord the Commission’s assessment ‘controlling weight unless [it is] arbitrary, or capricious, or manifestly contrary to the statute.’ ”) (quoting Chevron v. Natural Resources Defense Council, Inc., 467 U.S. 837, 844 (1984)). How redefining the meaning of fraud in

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Congressional purpose of ensuring “informed decision making by shareholders,”\textsuperscript{107} it has the effect of redefining fraud according to the discretion of the SEC.\textsuperscript{108}

V. CONCLUSION

The Court’s intentions in \textit{O’Hagan} were laudable. In enacting §10(b), Congress intended to limit fraudulent and deceptive acts in connection with the purchase or sale of securities by filling the statutory gaps left by §10(b) using the misappropriation theory.\textsuperscript{109} Yet, the Supreme Court has likely not seen the last of the misappropriation theory and §10(b). Likewise, litigation over what other elements of securities fraud the SEC can redefine to satisfy the “reasonably designed to prevent fraud” language of Rule 14e-3(a) is imminent. Henceforth, the SEC and other administrative agencies should feel uninhibited by the language of their statutory mandates in promulgating regulations to carry out their own agendas.

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the securities context is not contrary to the statute is unclear. The Rule, by its own terms, defines fraud as the mere possession “of material information [the actor] knows or has reason to know is nonpublic” without disclosure to the information’s source. 17 CFR §14e-3(a) (1996); \textit{see also O’Hagan}, 117 S. Ct. at 2228 (Thomas, J., dissenting) (“the Rule, on its face, does not purport to be an exercise of the Commission’s prophylactic power, but rather a redefinition of what ‘constitute[s] a fraudulent, deceptive, or manipulative act or practice within the meaning of §14(e)’ ”).

\textsuperscript{107} Lewis v. McGraw, 619 F.2d 192, 195 (2d Cir. 1980) (per curiam) (“very purpose” [of Williams Act] was “informed decision making by shareholders”). The effect of rule 14e-3(a) would require a party owing no duty to the shareholders of a company to sit idle or disclose the information to the public, causing even more harm to the shareholders.

\textsuperscript{108} \textit{O’Hagan}, 117 S. Ct. at 2228 n.10 (Thomas J., dissenting) (noting that allowing the SEC to give its own construction to a statute brings into question whether the court performing an executive function or a lawmaking function) (citing \textit{J.W. Hampton, Jr. & Co. v. United States}, 276 U.S. 394, 409 (1928)).

\textsuperscript{109} However, as Justice Powell noted, “there are always winners and losers; but those who have lost have not necessarily been defrauded” under §10(b). \textit{Dirks v. SEC}, 463 U.S. 646, 667 n.27 (1983).