

Articles

JOE SIX-PACK, *UNITED STATES V. O'HAGAN*, AND PRIVATE SECURITIES LITIGATION REFORM: A LINE MUST BE DRAWN

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I. AN INTRODUCTION TO THE ISSUES

A. *The Setting*

1. *Judicial*

The pendulum has swung back once again. The "misappropriation theory"¹ indeed lives. Prosecutors are now both encouraged and enabled to pursue

1. A government-created method of extending liability for insider trading under § 10(b) and Rule 10b-5, articulated most precisely by former Chief Justice Warren Burger, while dissenting in, *Chiarella v. U.S.*, 445 U.S. 222 (1980), which the government lost:

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.

The language of § 10(b) and of Rule 10b-5 plainly supports such a reading. By their terms, these provisions reach *any* person engaged in *any* fraudulent scheme. This broad language negates the suggestion that congressional concern was limited to trading by "corporate insiders" or to deceptive practices related to "corporate information." Just as surely Congress cannot have intended one standard of fair dealing for "white collar" insiders and another for the "blue collar" level. The very language of § 10(b) and Rule 10b-5 by repeated use of the word 'any' [was] obviously meant to be inclusive.

Id. at 240 (emphasis in original).

insider trading on this rationale using § 10(b) and its Rule 10b-5 under the Securities Exchange Act of 1934.²

This recent major victory for securities regulators comes directly from a somewhat unique and far-reaching new coalition on the Supreme Court led by Justice Ruth Bader Ginsburg (appointed by President Clinton), the author of the groundbreaking new opinion, who was joined by five other justices in the recent decision of *United States v. O'Hagan*.³

Without much surprise to experienced court watchers, Justices Breyer (a President Clinton appointee), Souter (appointed by President Bush), and Stevens (appointed by President Carter), sided with the majority. Predictably, Chief Justice Rehnquist (appointed by President Nixon), Justice Scalia (appointed by President Reagan), and Justice Thomas (appointed by President Bush) agreed in a scathing dissent.⁴

The big news to many lawyers and academics⁵ was the alignment with the majority of the two other appointees of President Reagan, Justices O'Connor and Kennedy. Previous opinions written by each of them⁶ seemed to have indicated a reluctance to accept the misappropriation theory and, indeed, a hesitation to extend § 10(b) as a prosecutorial weapon at all.

With this new majority, the way is paved for a more aggressive criminal pursuit of "inside" traders by the SEC. At the same time, there are major questions left unresolved and critical reasons to significantly restrict the use of this theory in private civil causes of action. Regrettably, judicial activism with a vague statute and recent federal legislation encouraging individual plaintiffs appear to be directing us the opposite direction.

2. Legislative

After years of relative dormancy, the right of an individual investor or would-be purchaser or seller of shares, not in possession of material, nonpublic information, to sue an alleged insider or tippee has recently resurfaced. In 1988, Congress adopted § 20(A) of the Securities and Exchange Act of 1934, allowing a

2. See *United States v. O'Hagan*, 117 S. Ct. 2199, 2206 (1997).

3. *Id.*

4. *Id.* at 2220-31.

5. For early prognostications, see, for example, Wade M. Hall, *Insider Trading Liability: Are We Ready to Leave the Misappropriation Theory Quagmire?*, 44 U. KAN. L. REV. 867 (1996); Audrey Strauss & Lisa Fishbone, *Insider Trading After Chestman*, 793 PLI/CORP. 365, 374 (1992), available in WL, PLI/Corp. Library; Thomas Lee Hazen, *United States v. Chestman—Trading Securities on the Basis of Nonpublic Information in Advance of a Tender Offer*, 57 BROOK. L. REV. 595, 597 (1991); Steven R. Salbu, *The Misappropriation Theory of Insider Trading: A Legal, Economic, and Ethical Analysis*, 15 HARV. J.L. & PUB. POL'Y 223 (1990).

6. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 173-78 (1994) (Kennedy, J.); *Basic Inc. v. Levinson*, 485 U.S. 224, 256-57 (1988) (O'Connor, J., concurring in part and dissenting in part).

private civil suit by a "contemporaneous trader" against an individual defendant who made his trade based on material nonpublic information.⁷

Then just three years ago, Congress passed the Private Securities Litigation Reform Act of 1995⁸ ("Reform Act") to guide the conduct of private lawsuits that allege violations of the anti-fraud provisions of the 1933 and 1934 Acts,⁹ such lawsuits being the major method for compensating defrauded investors. On November 4, 1998, President Clinton signed into law S.1260, known as the Securities Litigation Uniform Standards Act of 1998, which was recently passed by both houses of Congress to further limit securities class actions in state court.¹⁰

The list of possible abuses of such private litigation has long been cited by the members of the United States Supreme Court, including the uncertain identity of plaintiffs, the ability of stock market speculators to seek the protection of this law, the scope and calculation of highly conjectural damages, problems of proof as to whether a trade actually would have ever occurred and the likelihood of enormous numbers of federal lawsuits surfeiting our already crowded courts.¹¹

Of equal importance, little mention has been made of whether Congress should actually be in the business of protecting speculators or even passive investors (so-called Joe Six-Packs) who essentially gamble on the continuation of lofty returns by well-marketed mutual funds without any interest in, or knowledge of, the individual corporate stock components or management of their funds' portfolio. It is now estimated that twelve percent of all daily trades over the NASDAQ are made by so-called "day-traders," individuals who make hundreds of transactions in dozens of stocks each day.¹² "What we try to teach people is that in day trading, stocks aren't stocks. They are four-letter symbols for making money."¹³

7. The Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA") 15 U.S.C. § 78t-1 (1994). Essentially a successor to the "Insider Trading Sanction Act of 1984," Congress noted upon ITSFEA's adoption that ITSFEA's private right of action, created under the newly promulgated § 20(A) is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendants' violation is premised upon the misappropriation theory. *See* Hall, *supra* note 5, at 883. However, no language to that effect was included in the final statutory section.

8. 15 U.S.C. § 78u-4 (Supp. 1996).

9. *Id.*

10. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (to amend 15 U.S.C. §§ 77p, 78bb).

11. *Chiarella v. United States*, 444 U.S. 222, 231 (1980) (Justice Powell noting that in the absence of a clearly-defined group to whom the defendant owes a duty, plaintiff identification is uncertain); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 734-35 (1975) (Justice Rehnquist addressing the problems of uncertain damages and hypothetical trades, and concluding that a widely-expanded class of plaintiffs will result in more litigation).

12. James B. Kelleher, *Got To Be Quick*, SAN DIEGO UNION TRIB., Apr. 14, 1998, at C1.

13. *Id.* (quoting Dan Mirkin).

However, the *O'Hagan* decision, together with the adoption of both § 20(A) and the Reform Act, create a serious concern that Congress and the courts could now be in the business of protecting hypothetical transactions—a most dangerous game.¹⁴

After a brief summary of these issues and their origins, this Article will explore the history of the 1934 Act, its well-known Rule 10b-5 and judicial interpretations leading up to *O'Hagan*. The Article then focuses on the dangers and weaknesses of the now viable misappropriation theory when applied to individual civil causes of action, concluding with both legislative and judicial recommendations for its future use.

B. Brief Capsule

1. The First Wave

From a macro perspective, the *O'Hagan* decision is merely the latest swing of the Supreme Court from one pole to the other concerning this controversial New Deal legislation.¹⁵

It should be noted initially that Rule 10b-5¹⁶ is not a congressional enactment, but rather an SEC promulgation under § 10(b). Created in 1948, the Rule was used for the first couple of decades by the lower federal district and circuit courts to facilitate pro-prosecutorial efforts against insider trading. Opinions were filled with aggressive judicial activism, expanding the scope of the legislation beyond what many believed was the original congressional intent.¹⁷

Contrariwise, in the early years of Rule 10b and § 10(b)(5) litigation, the United States Supreme Court regularly denied certiorari and allowed the Second Circuit Court of Appeals, particularly, to be the "Mother Court" in this field.¹⁸

Historically, the legislative intent of § 10(b) is quite perplexing when it is compared to its sister provisions, §§ 16(a) and (b), adopted at the same time.¹⁹ This latter 1934 Act, commonly called the "short swing profits" statute, was written by the identical Congress in a completely different and more comprehensive style allowing relative ease of interpretation and application.

14. By comparison, the Securities Act of 1933 is not intended to tell any individual whether or not to buy or sell a stock. It essentially demands full disclosure of all material information. See 15 U.S.C. §§ 77a-77aa (1994).

15. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). These opinions, authored by Justices Rehnquist, Powell, and White, respectively, restricted the availability of Rule 10b-5 as a prosecutorial weapon.

16. 17 C.F.R. § 240.10b-5 (1998).

17. Congressional inaction was perhaps best summarized by the Supreme Court itself when it said "[t]hat task, [interpreting § 10b] it would appear, Congress has left to us." *Musick Peela & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 294 (1993).

18. See *Blue Chip Stamps*, 421 U.S. at 762; *United States v. Re*, 336 F.2d 306 (2d Cir. 1964), *cert. denied*, 379 U.S. 904 (1964).

19. 15 U.S.C. § 78p (1994).

Without such congressional guidance for § 10(b), however, the expansive "judicial legislation" focus of Rule 10b-5 reached its zenith in 1968, with the landmark Second Circuit conviction in *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*,²⁰ from which certiorari again was denied.²¹

2. Initial Flow Away

Starting in the mid-1970s and continuing for almost a decade thereafter, the Supreme Court became active and swung the pendulum in the opposite direction. In a series of opinions written by then Justice Rehnquist, Justice White, and particularly Justice Powell (who authored three of them), the court restricted the expansion of § 10(b) significantly.²² As a result of these decisions, prosecution of insider trading declined, and the future of the Rule as a useful legal tool seemed limited.

Ironically, it was during this time, that Chief Justice Burger, in a dissenting opinion in the 1980 case of *Chiarella v. United States*,²³ urged the court to adopt a theory that when a person has "misappropriated" material nonpublic information that is entrusted to him in the utmost confidence and then essentially exploits that ill-gotten informational advantage by purchasing securities in the market, he should be found to have violated § 10(b) and Rule 10b-5.²⁴ However, due to faulty jury instructions, the full court refused to deal with that issue in *Chiarella*, leaving everyone unclear on this rationale until *United States v. O'Hagan*.²⁵

3. The Stalemate

During the late 1980s, the personal philosophy of jurists again intervened in the higher courts that reviewed insider trading litigation. The Justices of the United States Supreme Court and the judges of the Second Circuit Court of Appeals were almost evenly split on the application of the Rule.

To illustrate, in 1987 Justice Kennedy had not yet been sworn in before the well-publicized appeal of the insider trading case of front page *Wall Street Journal* writer, R. Foster Winans, convicted in the lower court on the misappropriation theory in *Carpenter v. United States*.²⁶ As a result, the Supreme Court split four to four in what should have been the definitive treatment of this rationale. Since "an affirmance by an evenly divided Court [is not] entitled to precedential weight,"²⁷ the Court's view of the theory still was unclear. How

20. 401 F.2d 833 (2d Cir. 1968), *cert. denied*.

21. 404 U.S. 1005 (1971).

22. *Dirks v. SEC*, 463 U.S. 646 (1983) (Powell, J.); *Chiarella v. United States*, 445 U.S. 222 (1980) (Powell, J.); *Santa Fe Industries Inc. v. Green*, 430 U.S. 462 (1977) (White, J.); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 185 (1976) (Powell, J.) *Blue Chip Stamps*, 421 U.S. at 723 (Rehnquist, J.).

23. *See Chiarella*, 445 U.S. at 239.

24. *Id.* at 245.

25. 117 S. Ct. 2199, 2206 (1997).

26. 484 U.S. 19 (1987).

27. *Neil v. Biggers*, 409 U.S. 188, 192 (1972).

Justice Kennedy would have voted is officially unknown, but in his subsequent majority opinion in *Central Bank of Denver v. First Interstate Bank of Denver*,²⁸ he led the court in again rejecting an extension of Rule 10b-5.

One year after *Carpenter*, Justice Blackmun, the great dissenter in the 1970s' insider trading cases that restricted § 10(b), finally was able to write a prevailing opinion in *Basic Inc. v. Levinson*.²⁹ However, he could only assemble a four to two plurality, with Chief Justice Rehnquist and Justices Scalia and Kennedy not participating.³⁰ While that decision upheld a lower court conviction, the division of the Supreme Court was apparent. Significantly, Justice O'Connor joined Justice White in a strong dissent urging Congress to be the source for expanding § 10(b) rationale, not the court.

Finally, in 1991, while attempting to resolve this Rule 10b-5 issue, the 2nd Circuit Court of Appeals assembled its entire court in a major misappropriation case, *United States v. Chestman*.³¹ However, one judge retired after hearing the case, and the remaining eleven split, five to five with one other separate opinion. Together with *Basic Inc. v. Levinson*'s³² four to two plurality, and the *Carpenter v. United States*'s³³ four to four "nonprecedential" split, these three cases demonstrated a virtual judicial deadlock in this area.

4. The Movement Back

*United States v. O'Hagan*³⁴ begins the fourth wave of insider trading cases. With Justices O'Connor and Kennedy shifting gears and joining the majority, the stage seems set for a new decade of pro-prosecutorial criminal rulings. How far the court will, and should, go in private civil cases is the major question reviewed in this Article.

Due to illness and long years of service, Justices Rehnquist and O'Connor have indicated that they may retire in the next couple of years.³⁵ If so, one major publication has already indicted that Justice Ginsburg is considered to be the likely replacement as Chief Justice.³⁶ Likewise, if a Democrat is elected president in the year 2000, then court appointments over the next several years should create a broader swing and continue the *O'Hagan* trend of expanding § 10(b) by an even larger majority.

28. 511 U.S. 164, 173-78 (1994).

29. 485 U.S. 224 (1988). See *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drugs*, 421 U.S. 723 (1975).

30. As a matter of historic policy, the Court does not reveal the reasons why justices do not participate in decisions.

31. 947 F.2d 551 (2d Cir. 1991), *cert. denied*, *Chestman v. U.S.*, 503 U.S. 1004 (1992).

32. 485 U.S. 224 (1988).

33. 484 U.S. 19 (1987).

34. 117 S. Ct. 2199, 2206 (1997).

35. Jeffrey Rosen, *The New Look of Liberalism of the Court*, NY TIMES MAG., Oct. 5, 1997, at 61.

36. *Id.* at 62.

One might well inquire whether the political philosophy of the Justices is the best method for resolving such major economic issues affecting millions of people. Admittedly, Congress has been of little help beyond its vague language in § 10(b) written over sixty years ago. Could it now be expected to play a larger role and provide guidance?

What are the dangers of this new wave, from both a doctrinal and political perspective? How can steps be taken to bring predictability and continuity to the field and who should do so? An analysis of these questions and a call for dual action are the thrust of the balance of this Article.

II. HISTORICAL BACKGROUND OF SECURITIES LAWS APPLICABLE TO INSIDER TRADING

A. *The Beginning*

At common law, the definition, issuance, purchase, and sale of securities were all regulated solely by the states.³⁷ As a general rule, a "director" or "officer"³⁸ of a corporation whose stock was publicly traded on a market was not required to disclose any inside, material information concerning his corporation before trading on that material information, even if that trade was based solely on such facts.³⁹ As a result, undisclosed good news led to significant profits on purchases, and inside knowledge of portending bad news led to short sales and similar gains by the trader.⁴⁰

Federal remedies seemed the only blanket answer. Motivated by the stock market crash of 1929 and the election of President Roosevelt three years later, Congress finally enacted a "Securities Act of 1933," ("1933 Act"),⁴¹ which, peculiarly, was to be administered by the Federal Trade Commission. This Act was directed primarily at the initial distribution of newly issued securities.

The theory behind the 1933 Act is that investors need to be adequately protected by a "full and fair disclosure" of all material information which a prospective purchaser would want to know before bringing a new issue.⁴² The

37. In 1911, the Kansas legislature adopted the first law in the nation governing securities transactions, and all 50 states have them now.

38. See, e.g., Barbara A. Ash, *State Regulation of Insider Trading—A Timely Resurgence?*, 49 OHIO ST. L.J. 393, 399 (1988).

39. *Smith v. Hurd*, 985 F.2d 574 (9th Cir. 1993) (unpublished table decision, available at 1993 WL 28366); *Blabon v. Hay*, 169 N.E. 268 (Mass. 1929).

40. Even today, in most jurisdictions, state courts have been reluctant to expand insider trader liability, specifically rejecting such Supreme Court rationales as "fraud on the marketplace," "presumptions of reliance and materiality," and when someone needs to disclose what may be "material information." *Diamond v. Oreamuno*, 248 N.E.2d 910 (N.Y. 1969); *Mirkin v. Wasserman*, 858 P.2d 568 (Cal. 1993); *Linder Fund, Inc. v. Waldbaum*, 624 N.E.2d 160 (N.Y. 1993).

41. 15 U.S.C. §§ 77a–77aa (1994).

42. See, e.g., Noelle Matteson, Comment, *Private Securities Litigation Reform Act of 1995: Do Issuers Still Get Soaked in the Safe Harbor?*, 27 GOLDEN GATE U. L. REV. 527–28 (1997).

1933 Act now includes a number of private remedies for investors.⁴³ There are general anti-fraud provisions preventing material omissions and misrepresentations in connection with the sale of securities; however, the scope of the 1933 Act is narrow, dealing only with distributions of securities and protecting just purchasers.

The more significant statute applying to trading is the Securities Exchange Act of 1934, ("1934 Act").⁴⁴ This omnibus bill was so broad that Congress created the Securities and Exchange Commission to administer the statute, relieving the FTC from its short lived administrative responsibilities in the securities field.

B. Contrast Between the Two Key Initial Sections of the 1934 Act

A startling comparison arises immediately between the two primary portions of the statute dealing with stock trades, § 10(b) and §§ 16(a) and (b). Both reveal much with regard to the scope and intent of Congress at the time.

1. Section 10(b)

Section 10(b) was designed to prohibit "manipulative" and "deceptive" devices employed in connection with the purchase or sale of any "security."⁴⁵ In relevant part, it provides simply that,

[I]t 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.⁴⁶

That was the extent of the language. Legislative history provided little guidance regarding the intent of Congress, thus giving the Securities Exchange Commission a greater authority, depending upon its philosophy, to use § 10(b) as a weapon to deal with allegedly manipulative or fraudulent securities conduct.

2. Section 16

A comparison between § 10(b) and §§ 16(a) and (b), the so-called "short swing" profit statute, shows dramatic differences in statutory intent.

Unlike § 10(b), § 16 does the following: it (a) defines who is covered (directors, officers, and ten percent shareholders); (b) requires the security to be traded on a "national securities exchange"; (c) forces such persons to file registration statements annually after any trades; (d) requires any party to

43. 15 U.S.C. §§ 77a-77aa (1994 & Supp. 1996).

44. 15 U.S.C. § 78a (1994).

45. 15 U.S.C. § 78j(b) (1994).

46. *Id.*

"disgorge" any "profit" realized from any purchase and sale or sale and purchase within any period of less than six months; (e) applies, with certain exceptions, "irrespective of intention"; (f) identifies the plaintiffs; and (g) creates a statute of limitations.⁴⁷

Contrariwise, with the vague § 10b, it took nine years after that statute was passed for the SEC, in 1943, to adopt Rule 10b-5,⁴⁸ which states 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,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁴⁹

47. 15 U.S.C. § 78p (1994).

48. 17 C.F.R. § 240, 10b-5 (1997).

49. A marvelous anecdote has been written about the origin of this Rule by Milton Freeman, who created it. Speaking in 1967 at a conference on the codification of the Federal Securities Laws, with Sumner Pike and the recently deceased Louis Loss on the panel, he said:

I think it would be appropriate for me now to make a brief statement of what actually happened when 10b-5 was adopted, where it would be written down and be available to everybody, not just the people who are willing to listen to me.

It was one day in the year 1943, I believe. I was sitting in my office in the S.E.C. building in Philadelphia and I received a call from Jim Treanor who was then the Director of the Trading and Exchange Division. He said, "I have just been on the telephone with Paul Rowen," who was then the S.E.C. Regional Administrator in Boston, "and he has told me about the president of some company in Boston who is going around buying up the stock of his company from his own shareholders at \$4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be \$2.00 a share for the coming year. Is there anything we can do about it?" So he came upstairs and I called in my secretary and I looked at Section 10(b) and I looked at Section 17, and I put them together, and the only discussion we had there was where "in connection with the purchase or sale" should be, and we decided it should be at the end.

We called the Commission and we got on the calendar, and I don't remember whether we got there that morning or after lunch. We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Even though it has been characterized as an anti-fraud provision, Rule 10b-5 has been used to bar insider trading without ever speaking of those terms. The legislative history gives some indication that insider trading is one of the evils the section was intended to address, but there is little evidence of what types of insider trading would be considered manipulative or deceptive within the meaning of the section.

Thus, the SEC and the courts were left with the task of defining the scope and characteristics of liability for insider trading. Commenting on the judicial expansion of this field thirty years after its adoption, Chief Justice Rehnquist described the Rule as "a judicial oak which has grown from little more than a legislative acorn."⁵⁰

C. Weapons for the Twenty-First Century

1. The Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA")⁵¹

Section 20(A)⁵² establishes a private cause of action against a defender trading on the basis of material, nonpublic information, by anyone who happens to "contemporaneously" trade on the other side of the market as the defendant:

Any person who violates any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security while in possession of material, nonpublic information shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that is the subject of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class.⁵³

It also creates a five-year statute of limitations following the date of the last violative transaction⁵⁴ and liability for those "controlling" the liable trader.⁵⁵ Before adoption of this Section, the courts were split as to the efficacy of such claims. However, even today serious questions remain about its definitions, particularly the word "contemporaneous"⁵⁶ and the validity of suing based upon transactions which might have occurred.

Louis is absolutely right that I never thought that twenty-odd years later it would be the biggest thing that had ever happened. It was intended to give the Commission power to deal with this problem. It had no relation in the Commission's contemplation to private proceedings.

Milton Freeman, *Administrative Procedures*, 22 BUS. LAW. 793, 922 (1967).

50. Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

51. 15 U.S.C. § 78 t-1 (1994). Note the rather bizarre numbering system of the 1934 Act. There are two Section 20 "alphas": § 20(A) and § 20(a).

52. 15 U.S.C. § 78t-1(a) (1994).

53. *Id.*

54. 15 U.S.C. § 78t-1(b)(4) (1994).

55. 15 U.S.C. § 78t-1(b)(3) (1994).

56. Congress did not create a new definition of the word "contemporaneous," but

That is, could an individual plaintiff (so-called "Joe Six-Pack") charge that had he known of the information motivating the defendant's illegal trade, he would have (or have not) bought (or sold) depending upon the movement of the stock price? If so, how does Joe prove damages? Such questions as what quantity of shares would he have bought or sold—and at what precise moment during the trading market's day of operation, need to be answered carefully in order to establish price and calculate damages. Of course, the actual market price would not be accurate either, because the volume of the defendant's illegal trades influenced that price. Should those trades thus be voided or excluded and the entire trading pattern of the day(s) in question recalculated? The enormity of these problems and their speculative calculations will be explored in this paper.

Confusingly, the other § 20 alpha is 20(a),⁵⁷ which establishes "controlling person" liability, presumably in favor of those who already have won their civil suit against the controlled person. Thus, it is distinctly possible for Joe Six-Pack to not only sue Mr. O'Hagan but, thereafter, his law firm.⁵⁸

Finally, the use of class actions encouraged under the Reform Act,⁵⁹ also opens up enormous opportunities for those who never had any dealings with, or even knew of, the defendants; a serious question discussed below.⁶⁰

To complete the overlapping and confusing numbering system, § 21(A)⁶¹ allows the SEC to bring a civil action against the violator for an antitrust-like treble damages penalty. It also may sue the "controlling person" of the trading

used its meaning as evolved from case law, albeit ambiguous. *See, e.g.,* Wilson v. Comtech Telecomm. Corp., 648 F.2d 88 (2d Cir. 1981); Shapiro v. Merrill Lynch, Inc., 495 F.2d 228 (2d Cir. 1974). These cases determined that "contemporaneous" means "at the same time as the insider or for some period thereafter, and that a reasonable period of liability could be as short as a few days but no longer than a month." *In re Verifone Secs. Litig.*, 784 F. Supp. 1471, 1489 (N.D. Cal. 1992).

57. This section states:

Every person who, directly or indirectly, controls any person liable under any provision of this title or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78t(a) (1994).

58. This section 20(a) imposes both joint and several liability on persons who control another who is liable for violations of the securities laws, but the plaintiff has to establish (a) a primary violation of some section of those laws, and (b) that the defendant actually exercised control over the party engaging in the unlawful conduct. *See, e.g.,* Simon v. American Power Conversion Corp., 945 F. Supp. 416 (D.R.I. 1996).

59. The Private Securities Litigation Reform Act of 1995, Pub L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (Supp. 1996)).

60. *See supra* notes 56–58. The primary focus of the Reform Act is on class actions as distinct from individual suits. Such class actions always have been strongly favored in securities fraud suits. *See, e.g., In re Cenco, Inc. Sec. Litig.*, 519 F. Supp. 322 (N.D. Ill. 1981); Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968).

61. 15 U.S.C. § 78u-1 (1994).

defender, which could well include a law partnership or CPA firm. Moreover, the 1934 Act now gives the SEC the extraordinary weapon to pay a "bounty" to informants.⁶²

Thus, statutory as well as judicial weapons have been created which could well lead to an enormous increase in civil litigation. Essential congressional definitions and guidance, however, remain missing, vague, or uncertain.

2. The Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998

Passed by a heavily Republican Senate over President Clinton's veto, the 1995 Reform Act⁶³ was intended to greatly impact federal private lawsuits for securities fraud, whether by way of class action or individually. While such suits frequently provide the only practical way to compensate defrauded small investors, defense counsel, of course, believe that these are the very type of claims most prone to abuse. Class actions invariably require expensive and time-consuming discovery, virtual origination and control by plaintiffs' lawyers, and a potential for exorbitant attorneys' fees and judgments.

When passing the Reform Act, Congress attempted to curb these potential abuses by adopting the following principal rules to be applied to federal securities cases: (1) a "safe harbor" period for forward-looking statements by the issues about its prospective performance;⁶⁴ (2) a stay of discovery while the inevitable motion to dismiss is being decided;⁶⁵ (3) tougher pleading standards requiring a specific recital of facts showing a "strong inference" of fraud;⁶⁶ (4) a "lead

62. (e) Authority to award bounties to informants

Notwithstanding the provisions of subsection (d)(1) of this section, there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payments, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.

15 U.S.C. § 78u-1(e) (1994).

63. Pub. L. No. 104-67, 109 Stat. 737, codified at 15 U.S.C. § 78u-4 (Supp. 1996).

64. No appellate cases have yet been decided on this subsection, but early lower court filings under this particular theory have been extremely rare.

65. Defense counsel almost universally files such a motion. See Martin, Juneja, Foster & Dunbar, *Recent Trends IV, What Explains Filings and Settlements in Shareholder Class Actions*, N.E.R.A., Nov. 1996; Rodd Zolkes, *No Filings in Securities Suits Field*, BUS. INSURANCE, Dec. 16, 1996, at 3.

66. The Section states:

(1) Misleading statements and omissions.

In any private action rising under this chapter in which the

plaintiff' provision designed both to take control of class action litigation away from the lawyers and to encourage institutional shareholders to sue;⁶⁷ and (5) a system of proportionate, non joint and several, liability of defendants who are not found to have knowingly committed fraud; that is, those who had no scienter.⁶⁸

plaintiff alleges that the defendant—

(A) made an untrue statement of a material fact; or

(B) omitted to state a material fact necessary in order to make the statements made, in the light of the circumstances in which they were made, not misleading;

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

(2) Required state of mind.

In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

(3) Motions to dismiss; stay of discovery.

(A) Dismissed for failure to meet pleading requirements

In any private action arising under this chapter, the court shall, on the motion of any defendant, dismiss the complaint if the requirements of paragraphs (1) and (2) are not met.

15 U.S.C. § 78u-4(b) (Supp. 1996). A major split exists in the federal courts as to whether the law merely adopted the Second Circuit's tough pleading criteria from *In re Time-Warner, Inc. Securities Litigation*, 9 F.3d 259 (2d Cir. 1993), or a stricter one requiring conscious acts, not mere recklessness. *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746 (N.D. Cal. 1997); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42 (D.C. Mass. 1997).

67. The person selected as the class representative must be one who has been injured and did not sell or purchase securities in order just to become part of the class action. 15 U.S.C. § 78u-4(a)(2)(A)(ii) (Supp. 1996). The selected representative is also not allowed to accept any payment beyond his pro rata share in the action for being the class representative. *Id.* § 78u-4(a)(2)(A)(iv). Once a complaint is filed, "within 20 days the plaintiffs must publish, in a widely circulated, national, business oriented publication or wire service, a notice advising members of the purported plaintiff class, the claims asserted, the class period, and that any member of the class can move to become lead plaintiff." A lead plaintiff will be chosen by the court within ninety days of the publishing of the notice. *Id.* § 78u-4(a)(3)(A). This provision is intended to raise the quality and presumably case merits of plaintiffs, but early cases have shown that it has little likelihood of doing so. See Joseph A. Grundfest & Michael A. Perino, *Securities Litigation Reform: The First Year's Experience (A Statistical and Legal Analysis of Securities Fraud Litigation Under the Private Securities Litigation Reform Act)*, John M. Olin Program in Law and Economics Working Paper Series, Stanford Law School, Working Paper No. 140, Feb. 1997 (manuscript on file with author).

68. Most practitioners consider this section to have a built-in effect of lowering damage awards from the former "out of pocket" test of what would have been the stock price without the fraud, to an average of actual prices subsequent to the fraud which, logically, would be influenced by other factors than the fraud itself.

a. Some Early Readings on the Reform Act

If a goal of Congress under the Reform Act was to encourage institutional investors to pay for and participate in such litigation, it seems to have failed, at least in its early years of existence. For numerous reasons, including cost, exposure to discovery, and public relations, large brokerage institutions rarely join as plaintiffs.

In prior years, plaintiffs' counsel raced to the courthouse for the specific purpose of being the first to file and thus control the suit (some pre-Reform Act cases had been filed as early as the day of the initial offering). Early cases filed under the new Reform Act have shown that plaintiffs are still hurrying to file. However, their goal now is to be the first to send out on the Internet the mandated "notice to others"⁶⁹ to join the case. This congressionally mandated marketing and extensive advertising by law firms of their proclaimed merits in order to remain as lead counsel will do nothing but increase litigation—the opposite of Congress' goal.⁷⁰

b. The 1998 Act

In the short period since the adoption of the Reform Act, state court class actions actually increased in number. Defense counsel argued in the early cases that the increase was attributable to plaintiffs' lawyers' efforts to avoid the Reform Act's provisions, particularly the tighter pleading requirements and discovery stay, which do not apply in state court. Plaintiffs allegedly engaged in wide, early discovery in the state court case with the intent to later use that evidence in the federal case—a clever backdoor circumvention of the Reform Act. Others pointed to the various pro-plaintiff advantages available in different jurisdictions, such as prior decisions accepting causes of action for aiding-and-abetting, the opportunity for nonunanimous jury verdicts and the right to seek punitive damages as reasons for the increase in litigation.

The Supreme Court's decision in *Matsushita Electric Industrial Co. v. Epstein*,⁷¹ also influenced this area. That case held that a state court judgment dismissing a state class action suit pursuant to a settlement agreement also could include a provision barring federal securities fraud class actions arising out of the same transaction, even if the state court initially lacked jurisdiction to adjudicate the federal claims.⁷² This ruling gave state courts control over a complete, global settlement of all such claims—an ironic twist. Perhaps most startling is that the California Supreme Court recently granted a hearing in a case seeking to submit both federal and state securities claims to California State Blue Sky laws—an extraordinary possibility.⁷³

69. § 78u-4(a)(3)(A)(i) (Supp. 1996).

70. § 78u-4(a)(3)(B)(iii)(I)(bb) (Supp. 1996).

71. 516 U.S. 367 (1996).

72. See Securities Exchange Act § 27, 15 U.S.C. § 78aa (1994) (establishing exclusive federal jurisdiction of Exchange Act claims).

73. Pass v. Diamond Multimedia Sup. Inc., Case No. C V-75 8927 (Santa Clara Cty. Sup. Ct. 1997).

These early post-Reform Act consequences prompted new federal legislation. Signed into law in November 1998⁷⁴ by President Clinton, the new Securities Litigation Uniform Standards Act of 1998 appears to be a major step restricting the ability of investors to file class action shareholder lawsuits in state courts against corporations whose stock trades on major national exchanges.

Having vetoed the broader Reform Act, which is the only congressional enactment passed over President Clinton's veto during his six years in office, the President signed this bill, which appears at first glance to be more pro-executive. The Reform Act raises the bar over which shareholders must pass when they bring lawsuits attacking corporate earnings predictions and forecasts that prove erroneous.

In the findings leading toward the bill, Congress made the following statements:

The Congress finds that—

(1) the Private Securities Litigation Reform Act of 1995 sought to prevent abuses in private securities fraud lawsuits;

(2) since enactment of that legislation, considerable evidence has been presented to Congress that a number of securities class action lawsuits have shifted from Federal to State courts;

(3) this shift has prevented the Act from fully achieving its objectives;

(4) State securities regulation is of continuing importance, together with Federal Regulation of securities, to protect investors and promote strong financial markets; and

(5) in order to prevent certain State private securities class action lawsuits alleging fraud from being used to frustrate the objectives of the Private Securities Litigation Reform Act of 1995, it is appropriate to enact national standards for securities class action lawsuits involving nationally traded securities, while preserving the appropriate enforcement powers of State securities regulators and not changing the current treatment of individual lawsuits.⁷⁵

This new bill amends both the Securities Act of 1933 and the Securities and Exchange Act of 1934 to prohibit private class actions based upon a state statute or common law in either State or Federal court, by any party alleging (1) an untrue statement or omission in connection with the purchase or sale of a covered security, or (2) that the defendant used any manipulative or deceptive device in connection with such a transaction.⁷⁶ It also declares that any class action brought in any state court involving a covered security shall be removable to the federal district court for the district in which the action is pending.⁷⁷ While there are some

74. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (to amend 15 U.S.C. §§ 77p, 78bb).

75. *Id.* § 2 (to amend 15 U.S.C. § 78a).

76. *Id.* § 101(a)(1)(b)(1), (2) (amending 15 U.S.C. § 77p).

77. *Id.* § 101(a)(1)(c) (amending 15 U.S.C. § 77p).

exemptions still allowing class suits in somewhat limited circumstances,⁷⁸ the bill is a major step toward preempting state jurisdiction and will be a unique challenge to plaintiff's counsel seeking to enforce their client's rights.

c. The Tighter Pleading Objective

It is universally conceded that the Reform Act, at a minimum, adopted the Second Circuit's rule that a complaint must plead specific facts giving rise to a strong inference of the defendant's fraudulent intent. Whether the Reform Act went farther is much debated.

78. See *id.* §101(a)(1)(d) (amending 15 U.S.C. §77p).

(d) PRESERVATION OF CERTAIN ACTIONS.—

(1) ACTIONS UNDER STATE LAW OF INCORPORATION.—

(A) ACTIONS PRESERVED.—Notwithstanding subsection (b) or (c), a covered class action described in paragraph (B) of this paragraph that is based upon the statutory or common law of the State in which the issuer is incorporated (in the case of a corporation) or organized (in the case of any other entity) may be maintained in a State or Federal court by a private party

(B) PERMISSIBLE ACTIONS.—A covered class action is described in this subparagraph if it involves—

(i) the purchase or sale of securities by the issuer or an affiliate of the issuer exclusively from or to holders of equity securities of the issuer; or

(ii) any recommendation, position, or other communication with respect to the sale of securities of the issuer that—

(I) is made by or on behalf of the issuer or an affiliate of the issuer to holders of equity securities of the issuer; and

(II) concerns decisions of those equity holders with respect to voting their securities, acting in response to a tender or exchange offer, or exercising dissenters' or appraisal rights.

(2) STATE ACTIONS.—

(A) IN GENERAL.—Notwithstanding any other provision of this section, nothing in this section may be construed to preclude a State or political subdivision thereof or a State pension plan from bringing an action involving a covered security on its own behalf, or as a member of a class comprised solely of other States, political subdivisions, or State pension plans similarly situated.

(B) STATE PENSION PLAN DEFINED.—For purposes of this paragraph, the term "State pension plan" means a pension plan established and maintained for its employees by the government of the State or political subdivision thereof, or by any agency or instrumentality thereof.

....

(e) PRESERVATION OF STATE JURISDICTION.—The securities commission (or any agency or office performing like functions) of any State shall retain jurisdiction under the laws of such State to investigate and bring enforcement actions.

Id. §101(a)(1)(d) (amending 15 U.S.C. §77p).

In *In re Time Warner Inc. Securities Litigation*,⁷⁹ the Second Circuit held that a strong inference of scienter could be established: (1) by "alleg[ing] facts establishing a motive to commit fraud and an opportunity to do so" or (2) by "alleg[ing] facts constituting circumstantial evidence of either reckless or conscious behavior."⁸⁰ The Reform Act's pleading standard language only provides that a complaint must "state with particularity, facts giving rise to a strong inference that the defendant acted with the required state of mind."⁸¹ However, a uniform pleading standard has not materialized.⁸²

The Conference Report of the Managers preparing the Reform Act, in the text accompanying footnote twenty-three, states unequivocally that "because [it] intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law regarding pleading."⁸³ During the reargument in Congress, this footnote was cited as a major reason for President Clinton's veto of the bill by its sponsors, Senators Dodd and Domenici, who both said that the Reform Act did adopt the Second Circuit's pleading test.⁸⁴ Clearly the United States Supreme Court needs to clarify this area soon.

d. What Degree of Intent Is Required Now?

Another key issue remaining is whether allegations of "recklessness" or "motive and opportunity" are sufficient to satisfy the Reform Act's "strong inference" pleading standard, long a debated concept. Most courts that have considered the issue have held that (a) the Reform Act did not change the substantive law regarding the scienter required to establish liability under Section 10(b) and Rule 10b-5 and, therefore, recklessness suffices to plead scienter; and (b) the Reform Act's pleading standard should be applied in a manner consistent with Second Circuit case law.⁸⁵ Therefore, allegations of motive and opportunity

79. 9 F.3d 259 (2d Cir. 1993).

80. *Id.* at 268. The definition of recklessness has long been debated and interpreted variously by federal courts although the SEC uses the term as defined in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir. 1977).

81. 15 U.S.C. § 78u-4(b)(2) (Supp. 1996).

82. No one argues that a standard *less* than the Second Circuit's was adopted. The question is how much tougher will the courts make those requirements?

83. H.R. CONF. REP. NO. 104-369, at 41 (1995).

Regarded as the most stringent pleading standard, the Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard.

Id.

In a footnote, the Conference Committee stated: "For this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness." *Id.* at 48 n.23.

84. 141 CONG. REC. S17960, (Dec. 5, 1995).

85. In the Senate debates preceding passage of the Conference bill, its co-authors, Senators Dodd and Domenici, clearly argued that the Committee had adopted the Second Circuit's pleading standard. Senator Dodd stated:

may be sufficient to plead a "strong inference" of scienter.⁸⁶

More particularly, in *In re Baesa Securities Litigation*,⁸⁷ the Southern District of New York recently held that the Reform Act did not "disturb the substantive law of what is the required mental state for a securities fraud violation"⁸⁸ and rejected the contention that recklessness was not sufficient to satisfy the scienter requirement. The court went farther, holding that allegations of motive and opportunity may be sufficient to give rise to the strong inference of scienter required by the Reform Act.⁸⁹

Likewise, in *In re Health Management, Inc. Securities Litigation*,⁹⁰ the Eastern District of New York held that recklessness and motive and opportunity are sufficient to plead a strong inference of scienter under the Reform Act, because

the standard to be imposed by the [Reform Act] was to be one of 'knowing misbehavior', Congress knew well how to state that standard. The Court finds the omission of such language in the statute significant in concluding that the Second Circuit's pleading standard was not abrogated by the [Act].⁹¹

[I]nstead of trying to take each case that came under the second circuit, we are trying to get to the point where we would have well-pleaded complaints. We are using the standards in the second circuit in that regard, then letting the courts—as these matters will—test. They can then refer to specific cases, the second circuit, [or] otherwise, to determine if these standards are based on facts and circumstances in a particular case. That is what we are trying to do here.

141 CONG. REC. S17960 (Dec. 5, 1995).

86. *Zeid v. Kimberley*, 973 F. Supp. 910, 914 (N.D. Cal. 1997) ("[T]he failure to provide an alternative interpretation militates against completely dispensing with the Second Circuit's well-developed two-part inquiry." *Id.* at 917); *Rehm v. Eagle Fin. Corp.*, 954 F. Supp. 1246, 1252 (N.D. Ill. 1997) ("[W]e find that § 78u-4(b)(2) adopts the Second Circuit standard."); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1311 (C.D. Cal. 1996) (a review of the complete text of the legislative history "makes clear, there is no basis to conclude that Congress eradicated, *sub silentio*, the well-established 'motive and opportunity' test for examining scienter...").

87. 969 F.Supp. 238 (S.D.N.Y. 1997).

88. *Id.* at 242.

89. The court noted:

The first question raised by the pending motions to dismiss these consolidated class actions is whether the Private Securities Litigation Reform Act of 1995... (the "Reform Act") heightens the scienter requirement for liability in a private securities fraud action by requiring more than "recklessness." The answer is no. The second question is whether the Reform Act makes the pleading of "motive and opportunity" no longer automatically sufficient in this Circuit to raise the "strong inference" of fraudulent scienter. The answer is yes. The final question is whether plaintiffs should be given leave to re-plead to attempt to rectify this shortcoming. The answer is no.

Id. at 239.

90. 970 F. Supp. 192 (E.D.N.Y. 1997).

91. *Id.* at 201 (citation omitted).

Contrariwise, *In re Silicon Graphics, Inc. Securities Litigation*,⁹² and *Friedberg v. Discreet Logic Inc.*,⁹³ have looked at the statute's long legislative history and held that allegations of recklessness or motive and opportunity are no longer sufficient. There the courts stated that not only is the pleading standard higher under the Reform Act than the Second Circuit's test, but also that scienter needs conscious acts, not mere recklessness.⁹⁴

Thus, the door has been opened for conflicting and uncertain judicial interpretations of the same types of difficult and ambiguous issues found in § 10b cases. These concerns which have long troubled so many federal courts as well as the U.S. Supreme Court will continue—clearly an unacceptable prospect.⁹⁵

III. JUDICIAL AND ADMINISTRATIVE LEGISLATION: THE FIRST WAVE

There were four major cases dealing with Rule 10b-5 in the first quarter century after its adoption in 1943.

A. *Kardon v. National Gypsum Co.*

In *Kardon*,⁹⁶ a Pennsylvania District Court judicially created an implied cause of action under the Rule, although none had been urged by the SEC nor had Congress so provided in the underlying statute.⁹⁷ This decision, like many others in the early years, found culpability for insider trading only when there was a breach of a fiduciary relationship.⁹⁸

92. 970 F. Supp. 746 (N.D. Cal. 1997). The case has been split for purposes of appeal to the Ninth Circuit into *Janas v. McCracken*, Docket # 97-16204, and *Brody v. McCracken*, Docket # 97-16240. Oral argument in both cases was held on June 11, 1998, and the appeals are pending.

93. 959 F. Supp. 42, 49 (D. Mass. 1997) (appeal filed).

94. *Silicon Graphics*, 970 F. Supp. at 757; *Friedberg*, 959 F. Supp. at 49-50.

95. Whether the Act raises the quality and integrity of plaintiffs and their cases may never be proven. Certain jurisdictions, particularly the Northern District of California (encompassing Silicon Valley) and the Southern District of New York (encompassing Wall Street), major judicial players in this field, have been virtually unanimous in granting early motions to dismiss under the Act, most without leave to replead. Perhaps as a result, such cases are being filed in numerous, and previously unused, federal district courts and state courts around the country. It thus seems doubtful that any clear read of the Reform Act's success or failure is at least a few years away.

96. 73 F. Supp. 798 (E.D. Penn. 1947).

97. On that most fundamental issue, Justices Scalia, Rehnquist, Thomas, and White (until his retirement in 1993) have made strong comments in their Rule 10b-5 opinions that if they were hearing the "implied private cause of action" matter *ab initio*, they would not have created one. Judge Friendly in the landmark *Texas Gulf Sulphur* case made the same observation. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 865 n.1 (2d Cir. 1968) (Friendly, concurring).

98. The directors of a corporation were found liable for trading on inside information when they purchased stock from existing shareholders without disclosing to them that they had already negotiated the sale of the controlling block of company stock to others at a greater price than what they were paying the plaintiffs. The court held that the

The court concluded that "the existence of a [private] remedy is implicit under general principles of the law."⁹⁹ In essence, individual officers and directors trading on material insider information do not have to work for a registered corporation or one that is publicly traded to be guilty of violating 10b-5, and the corporation could be even a small, intrastate close entity, so long as it had at least some interstate commerce contact.¹⁰⁰

B. *Birnbaum v. Newport Steel Corp.*

In 1952, the Second Circuit decided *Birnbaum v. Newport Steel Corp.*,¹⁰¹ which materially restricted the scope of § 10(b). It held that an individual plaintiff had to be a purchaser or seller of the issuer's security to be in violation of § 10(b).¹⁰² Potential purchasers or sellers who claimed that they would have traded had they known of inside information were no longer allowed to sue, nor could actual shareholders who claimed that they would have traded had they known this information before hand. Moreover, the court stated that mere corporate mismanagement which drives a stock price down does not give rise to a § 10(b) case. Rather, any claim for such conduct belongs in the state courts.¹⁰³

The *Birnbaum* decision, like *Kardon* and other early insider trading cases, reflects an effort on the part of the court to stay within the narrow confines of Congress's initial concerns under the 1934 Act: proceeding against directors and other insiders abusing their positions of trust and confidence.¹⁰⁴ These two opinions sat somewhat idly for almost a decade until the SEC's philosophy developed that in addition to directors, officers, and controlling shareholders, others such as family, friends, and non-officer employees, were in positions to exploit material inside information not available to the investing public.

defendants had breached their fiduciary duty and committed fraud under the 1934 Act for failing to disclose this material information before trading. *Kardon*, F. Supp. at 801.

99. *Id.* at 802.

100. These days with computerized trading, it seems doubtful that there would be any trouble finding interstate commerce in virtually any trade other than an absolute one-on-one, private, non-public market purchase and sale of shares of a closely-held corporation in a single jurisdiction.

101. 193 F.2d 461 (2d Cir. 1952), *cert. denied*, 343 U.S. 956 (1952).

102. *Id.* at 463.

103. *Id.* at 464.

104. *See supra* notes 96-100 and accompanying text.

C. In the Matter of Cady, Roberts & Co.

Nine years later in *In the Matter of Cady, Roberts, & Co.*,¹⁰⁵ the SEC issued a landmark ruling¹⁰⁶ concluding that an investment banker and a broker working for his firm to whom he "tipped" material, nonpublic information, should both be treated as insiders in violation of Rule 10b-5.¹⁰⁷ In coming to this conclusion, the SEC created two categories of insiders: "traditional" and "nontraditional."¹⁰⁸ Traditional insiders were typically identified as directors, officers, or controlling shareholders who had always been considered such under common law. However, the SEC extended Rule 10b-5's duty to "disclose inside information or abstain from trading," to all persons who enjoy "a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose."¹⁰⁹ A further prong to this extension of § 10(b) that is to be considered is, "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those whom he is dealing."¹¹⁰

This has become known as the "disclose or abstain" rule. Anyone in possession of material inside information has to either disclose it to the investing public or if he chooses not to do so, abstain from trading. The SEC was extending liability not just to one who buys and sells stock based on inside information but even to an insider who merely "tips" someone else yet does not trade himself.¹¹¹

A closer analysis of *Cady, Roberts* reveals that it was both the initial government prosecution of insider trading and the first case in which § 10(b) was interpreted by the SEC to ban all securities trading based on misuse of inside corporate information, including market transactions consummated through an independent securities market.¹¹² The broker was held to derive insider liability through a tip from an insider without there being any pre-existing personal relationship of trust to serve as the basis of fraud.

Commission Chairman William Cary used these words, which were repeated in part in numerous subsequent U.S. Supreme Court decisions¹¹³ to describe the obligation to "disclose or abstain" from trading as consisting of

105. 40 S.E.C. 907 (1961). David Cowdin, both an investment banker with Cady, Roberts & Co., and a director of Curtiss-Wright Corp., attended a board meeting of the latter company. There he learned of a decision to reduce the corporation's dividend. Cowdin then left the board room and called a Cady, Roberts partner to inform him of the newly acquired information before it was publicly released. Based upon this information, the firm immediately sold Curtiss-Wright stock in all of its customers' accounts. Furthermore, it sold borrowed stock at the current market price in anticipation of a price decline after public disclosure of the dividend cut, at which point it purchased an equivalent number of shares to cover. In other words, the firm sold "short."

106. *Id.* at 910.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. See *Dirks v. SEC*, 463 U.S. 646 (1983) (Powell, J.); *Chiarella v. U.S.*, 445

two principle 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.¹¹⁴

Cady, Roberts gave the courts a starting point to evolve § 10(b) on the new rationale that it gave the outsider-investor a more level playing field in the stock market. Its assumption, of course, was that outsiders are innocent parties whom the law should be expected to protect. Events in the next few decades explored this question more carefully and offered quite a different answer. For the time being, however, the "test" of who was an insider and who was not would continually expand and confuse.

D. SEC v. Texas Gulf Sulphur Co.

In 1968, the Second Circuit established the starting point in the modern evolution of insider trading laws.¹¹⁵ This was the first appellate case to go beyond the common law and into the realm of § 10(b). It essentially expanded the SEC's administrative decision in *Cady, Roberts*.¹¹⁶ The court held officers, employees, and tippees liable for insider trading under Rule 10b-5.¹¹⁷ The ruling in *Texas Gulf Sulphur* went beyond the SEC's finding in *Cady, Roberts* by holding that anyone who traded on the information violated Rule 10b-5.¹¹⁸

U.S. 222 (1980) (Powell, J); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (White, J.); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (Powell, J.); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (Rehnquist, J.).

114. *In re Cady, Roberts & Co.* 40 S.E.C. 907, 912 (1961).

115. 401 F.2d 833 (2d Cir. 1968). The facts were quite dramatic. Texas Gulf Sulphur Co. employees detected a promising mineral deposit on company land in Ontario, Canada. It drilled an initial test hole which turned up extraordinarily promising results. Further analysis determined that the sample contained an extremely high level of valuable mineral content. *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 94 (10th Cir. 1971). The Company itself was held liable to selling shareholders for its mismanagement of the press release. At this point, drilling was suspended while the company sought to purchase surrounding land, arguably a legitimate business concern. One of the adjacent landowners sued the firm under contract law for wrongful use of its information when buying his land. The case was settled. *See M. SHULMAN, THE BILLION DOLLAR WINDFALL*, Ch. 7 (1969).

During this period of drilling suspension, corporate officers, having knowledge of this discovery, made extensive purchases of Texas Gulf Sulphur stock in the open market, before any public disclosure of the discovery was made. Moreover, several corporate individuals (some were key officers; others, remote employees with officer titles) also bought stock. In 1991 with no guidance from Congress, the SEC itself finally defined an "officer" for Section 16(b) purposes, as including only the issuing company's president, principal financial and accounting officers, any vice president in charge of a principal part of the issuers operation and any other "policy makers." 56 FED. REG. 7242 (1991) (codified at 17 C.F.R. § 240.16a-1 (1993)).

116. *Cady, Roberts*, 40 S.E.C. 907 (1961).

117. *Id.*

118. *Texas Gulf Sulphur*, 401 F.2d at 848.

The court reiterated the *Cady, Roberts* test that "anyone in possession of material inside information must either disclose it to the investing public, or, if...he chooses not do to so, [he] must abstain from trading in or recommending the securities concerned while such insider information remains undisclosed," but the prohibition on trading on nonpublic information within Rule 10b-5 applied to "anyone in possession" (including non-insiders) of material nonpublic information. As a result, the court no longer limited insider trading liability to situations involving breach of a fiduciary duty.¹¹⁹

In addition, the Second Circuit...set forth its test of materiality of non-public information indicating that it would depend upon 'a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event' and how a 'reasonable' man would attach importance to the information in determining his choice of action.¹²⁰

Then, in a major effort to define the objectives of Rule 10b-5, which Congress had not done, the court shifted from the mere prevention of insider misconduct to the promotion of "equal access" to information by all potential traders in a so-called ideal, "efficient market."

The court stated:

By [the 1934] Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter or on exchanges....

The Rule 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.... The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for the corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing."¹²¹

Again, the assumption was that individual potential plaintiffs were innocent victims of an unequal stock market. The court expanded this theory, implying that merely trading based on material nonpublic information may itself defraud the market. This established a rebuttable presumption of "reliance" on the part of the plaintiff, and eliminated the need for privity or a relationship between

119. *Id.*

120. James H. Cheek, III, *The Ever Developing Law of Insider Trading*, C903 ALI-ABA 439, 442 (Feb. 24, 1994) (quoting from *Texas Gulf Sulphur*). See also Lisa J. Finnell, Comment, *United States v. Carpenter: Second Circuit Overextends the Misappropriation Theory of Criminal Liability Under Rule 10b-5*, 12 DEL. J. CORP. L. 605, 606 (1987).

121. *Texas Gulf Sulphur*, 401 F.2d 848 (quoting *Cady, Roberts*, 40 S.E.C. 907, 912 (1961)).

the buying shareholder and the defendant seller. Causation, likewise, could not be found under this general fraud theory.¹²²

Further, the court measured the damage by calculating how long it would take a reasonable investor to trade after becoming aware of the information.¹²³ The court also tried to give some help as to when insiders could trade by saying that they should wait "until the news could reasonably [be] expected to appear over the media of widest circulation, the Dow Jones broad tape," certainly an archaic concept today.¹²⁴

Judge Friendly, in a concurring footnote, said that were he considering the question of the existence of an "implied private cause of action" *ab initio*, he would not have favored it himself, raising the same question which several Supreme Court Justices would address similarly in later cases.¹²⁵

Over the next several years the SEC relied heavily on *Cady, Roberts* and *Texas Gulf Sulphur* to proceed more vigorously in prosecuting nontraditional insiders who were trading on nonpublic information. However, the U.S. Supreme Court did not deal with the statute in any meaningful way and continued to deny certiorari, thus perpetuating uncertainty in the field.

IV. THE 1970S—THE PENDULUM SWINGS BACK

Suddenly in the mid-1970s the Supreme Court quickly decided a series of opinions restricting Rule 10b-5. The composition of the court had changed with several appointments by President Nixon. Then Justice Rehnquist joined together with Justice White (a Kennedy appointee) and Justice Powell (a Nixon appointee), in putting the brakes on any expansion of this rule. The battle lines had been drawn between conservatives and liberals once again—particularly Justices Powell and Blackmun, both Nixon appointees, yet diametrically opposed on this issue.

A. Blue Chip Stamps v. Manor Drug Stores

In 1975, the Court in *Blue Chip Stamps v. Manor Drug Stores*,¹²⁶ essentially confirmed *Birnbaum v. Newport Steel*,¹²⁷ holding that a plaintiff under Rule 10b-5 must be a purchaser or a seller and that corporate mismanagement is not a 10b-5 violation. The majority opinion, written by Justice Rehnquist, reasoned that to rule otherwise would open the courts to literally tens of thousands of speculators who could argue that they would have bought or sold had they only

122. *Id.* at 848-49.

123. *Id.* at 851-52.

124. *Texas Gulf Sulphur*, 401 F.2d at 854.

125. *Id.* at 865 n.1 (Friendly, concurring). See *Dirks v. SEC*, 463 U.S. 646 (1983) (Powell, J.); *Chiarella v. United States*, 445 U.S. 222 (1980) (Powell, J.); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (White, J.); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (Powell, J.); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (Rehnquist, J.).

126. 421 U.S. at 747-49.

127. 193 F.2d 461, 463-64 (2d Cir. 1952).

known of the information.¹²⁸ Moreover, the calculations of damages would be virtually impossible. This opinion was almost a direct refutation of *Texas Gulf Sulphur*.

Justice Powell not only concurred with the decision but argued that the Court should have gone further to say that 10b-5 should not even be applied to insider trading. He urged that § 16(b) (the six-month automatic violation rule by officers, directors, and ten percent shareholders) should be the sole statute applying to cover this field.¹²⁹

Contrariwise, in a strong dissent, Justice Blackmun, together with Justices Marshall and Brennan, argued that *Birnbaum* should be overruled. Their view was that even a nontrading plaintiff should be able to recover if he can show that he would have bought or sold had he known the material information which influenced the defendant's action.¹³⁰

B. Ernst & Ernst v. Hochfelder

One year later in 1976, in *Ernst & Ernst v. Hochfelder*,¹³¹ Justice Powell wrote a majority opinion that limited liability under Rule 10b-5. He held that a CPA firm, which allegedly wrote a negligent report which the plaintiffs claimed induced them not to buy stock, could not be held to "aid and abet a violation." Instead, he said, "scienter was needed: an intent to defraud, manipulate or deceive the market."¹³² Justice Blackmun again wrote a vigorous dissent, arguing that the negligent creation of misleading corporate documents is enough for liability.¹³³

C. Santa Fe Industries v. Green

Then in *Santa Fe Industries v. Green*, Justice White and the Court again reversed a Second Circuit decision which upheld 10b-5 liability, and rejected the SEC's amicus curiae brief for that doctrine's extension, by holding that "mere unfairness" is not enough for a 10b-5 violation.¹³⁴

"Deception is required in order to violate that section," concluded the Court. The case involved a "reverse merger" by a ninety-five percent shareholder taking over the five percent minority under a Delaware statute allowing such action. The Court held that state courts were the ones to enforce such claims—not the federal courts under 10b-5.¹³⁵

While not misappropriation theory cases, these three decisions revealed a strong predisposition by certain justices about the nondesirability of judicial expansion of this vague congressional statute and SEC created rule. Each case

128. *Id.* at 749–50.

129. *See Blue Chip Stamps*, 421 U.S. at 756.

130. *Id.* at 764–66.

131. 425 U.S. 185, 187, 193 (1976).

132. *Id.* at 210–12.

133. *Id.* at 216–17.

134. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 464, 477 (1977).

135. *Id.* at 477–78.

urged Congress to act, and in each decision the majority opinion justices spoke of the regrettable earlier judicial creation of an implied private cause of action, with which they reluctantly had to live.¹³⁶

V. EARLY MISAPPROPRIATION CASES—THE OPPORTUNITY FOR A QUICK KNOCKOUT

Reeling from these three so-called “anti-10b-5” Supreme Court decisions, the SEC started to evolve a new doctrine, primarily based upon “stealing” and trading upon material, nonpublic information. The Second Circuit was ready to listen.

A. *United States v. Chiarella*

In one of the most celebrated insider trading cases, *United States v. Chiarella*,¹³⁷ the Second Circuit again applied its theory of equal access to the market from *Texas Gulf Sulphur*, in upholding the conviction of a financial printing company’s line employee who traded based upon nonpublic information which he gained in the course of his employment.¹³⁸

Chiarella’s main argument on appeal of his District Court conviction under Rule 10b-5 was that he was not a corporate insider of the companies targeted for takeover and, therefore, he had no fiduciary duty to disclose or abstain from trading.¹³⁹

Although Chiarella’s information did not come from insiders, the Second Circuit said that this was not necessary to find liability.¹⁴⁰ Instead the court focused on what it termed the “unfair advantage” obtained when information that has not yet been made public is used in trading. In holding that Chiarella’s activity constituted a violation of Rule 10b-5, the court stated, “[a]nyone corporate insider or not who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose.”¹⁴¹

136. See *id.*; *Ernst & Ernst*, 425 U.S. at 196; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729–30 (1975).

137. 588 F.2d 1358, 1365–66 (2d Cir. 1978).

138. *Chiarella*, 588 F.2d at 1363–64. Vincent Chiarella was a printer who worked as a “markup man” in a New York financial printing firm. Among the confidential documents that he handled were announcements of corporate takeover bids. The names of the corporations were either left blank or disguised using false names. Chiarella, however, was able to figure out which corporations were involved. Without disclosing this knowledge, he purchased stock in the target corporations. Furthermore, he immediately sold his shares after the takeover bids were made public.

139. *Id.* at 1364.

140. *Id.*

141. *Id.* at 1365.

*B. The Supreme Court's Incomplete Response: Chiarella v. United States*¹⁴²

The stage was thus set for Justice Powell and the Court to confront this new misappropriation theory. The general feeling at the SEC and among corporate practitioners in this field was that the *Chiarella* case would be the ultimate decision on the doctrine. Unfortunately, this would be the first of many disappointments with Supreme Court decisions in this area in the late 1980s.¹⁴³

Under its new theory, the SEC argued that criminal liability under § 10(b) should be extended to persons who trade on information in violation of a duty to their employers, and thus, to the corporations retaining their employers, even though they have not violated a duty to the persons with whom they trade. Essentially, no privity existed with those on the opposite side of *Chiarella's* trades in an anonymous market.

The majority opinion, written by Justice Powell, (four years after he wrote *Ernst & Ernst*) again reversed the Second Circuit over a scathing dissent by Justice Blackmun.¹⁴⁴ While the Court stated that *Chiarella* was not guilty of violating Rule 10b-5 because "a duty to disclose under § 10(b) does not arise [with] the mere possession of nonpublic market information,"¹⁴⁵ the primary focus of the decision was on the jury instructions given by the lower, convicting court. These instructions failed to instruct "on the nature or elements of a duty...to anyone other than the sellers."¹⁴⁶ The Court itself refused to "speculate upon whether such a duty exists, whether it has been breached, or whether such a breach constitutes a violation of Section 10(b)."¹⁴⁷

Justice Stevens, who provided the critical fifth vote for the majority opinion, wrote separately to stress that the Supreme Court had not decided whether *Chiarella's* "breach of his duty of silence—a duty he unquestionably owed to his employer and to his employer's customers—could give rise to criminal liability under Rule 10b-5."¹⁴⁸ In Stevens' view,¹⁴⁹

Respectable arguments could be made in support of either position. On the one hand, 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

142. 445 U.S. 222 (1980).

143. By way of historic origin, the misappropriation theory grew out of the argument presented by the SEC and prosecutors to the Supreme Court in *Chiarella*. As an alternate basis to strict 10b-5 analysis for supporting *Chiarella's* conviction, the government urged that the court could find that *Chiarella*, by using information obtained in the course of his employment, breached a duty owed to his employer (the print shop) and, thus, to his employer's customers (the acquiring companies). It is interesting to note that posted on the wall above *Chiarella's* station was a warning sign about the confidentiality of the material with which he was working. He ignored and violated it, but the question was whether this should be merely employee misconduct or a violation of federal law.

144. See *Chiarella*, 445 U.S. at 239.

145. *Id.* at 223.

146. *Id.* at 236.

147. *Id.* at 236–37.

148. *Id.* at 238.

149. *Id.*

constituted "a fraud or a deceit" upon those companies "in connection with the purchase or sale of any security." On the other hand, inasmuch as those companies would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers nor sellers of target company securities, it could also be argued that no actionable violation of Rule 10b-5 occurred. I think the court wisely leaves the resolution of this issue for another day.¹⁵⁰

On the other hand, Chief Justice Burger outright dissented, endorsing the misappropriation theory, by stating:

In particular, the rule should give way when an informational advantage is obtained, not by superior experience, foresight or industry, but some unlawful means.... I would read [Section] 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.¹⁵¹

Justice Burger concluded that the government's alternative argument had been properly presented to the jury. He voted to uphold Chiarella's conviction based on the argument that a person who misappropriates nonpublic information has a duty to disclose that information or to refrain from trading. Burger concluded that the language of Rule 10b-5 imputes insider trading liability to "any person engaged in a fraudulent scheme."¹⁵²

He also noted that the two factors mentioned in *Cady, Roberts*¹⁵³ that impose a duty to disclose on corporate insiders—(1) access to information intended to be available only for a corporate purpose, and (2) the inherent unfairness in trading on such information when it is not public—do not necessarily limit the application of federal securities laws to trading by corporate insiders who use corporate information.¹⁵⁴

Thus, in *Chiarella*, four members of the Court indicated that liability for insider trading could be imposed in the absence of a pre-existing relationship between buyer and seller; however, the crucial fifth vote swinging the law toward the prosecution was missing.

150. *Id.* (citation omitted). Justice Stevens' position—that he did not believe it was the time for the High Court to address such a problem—changes eighteen years later, when he becomes a key player in the current lineup of the Court. *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).

151. *Chiarella* 445 U.S. at 240 (Burger, C.J., dissenting).

152. *Id.*

153. *In re Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

154. Previously, in *Ernst & Ernst v. Hochfelder*, Justice Powell wrote for the Court that § 10(b) and Rule 10b-5 required scienter for liability. In that case, the Court found that an allegedly negligent audit which led plaintiffs to buy and/or sell, was not "aiding and abetting" nor a fraud on the market. Justice Blackmun strongly dissented. Later, Powell would pose similar compelling arguments in *Dirks v. SEC*, 463 U.S. 646 (1983).

C. Congress and the Second Circuit React

1. The Legislative Response

In apparent retaliation against *Chiarella*, four months later the SEC adopted Rule 14e-3, under the 1934 Act.¹⁵⁵ The rule imposed a

duty of disclosure under Section 14(e) on any person who trades in securities which will be sought...in a tender offer while that person is in possession of material information which he knows or has reason to know is nonpublic and has been acquired directly or indirectly from the...issuer or from an officer, director, partner or employee or any other person acting on behalf of the...issuer.¹⁵⁶

Clearly focusing on *Chiarella*, the SEC described the purpose of this new Rule as follows: "[This] rule pertains to trading by persons in securities which may be the subject of a tender offer as well as tipping of material, nonpublic information relating to a contemplated tender offer. It should be noted that Rule 14e-3 applies only in the context of tender offers."¹⁵⁷ Thus, a new weapon was made available to prosecutors.¹⁵⁸

Interestingly, one question remaining after adoption of this Rule was whether the "equal access to the stock market" theory was available to plaintiffs in nontender offer cases. Justice Blackmun's dissent in *Chiarella* suggested that certain situations may cause nondisclosure to violate §10(b) if one has a unique, albeit temporary relationship with the issuer giving him superior information to the general marketplace, for example, accountants, lawyers, or consultants working on a particular project.¹⁵⁹ While no formal duty to disclose existed, Blackmun argued none was needed.¹⁶⁰ In other words, the "disclose or abstain" rule was still viable.

2. The "Mother Court's"¹⁶¹ Response

a. *United States v. Newman*

Soon after the Supreme Court's decision in *Chiarella*, the SEC and lower courts quickly embraced the misappropriation theory as a means to prosecute trading by outsiders based upon insider information. In *United States v. Newman*,¹⁶² the SEC indicted James Newman, a registered securities trader and analyst, and charged him with violating § 10(b) and Rule 10b-5 for his role in

155. Tender Offers, 45 Fed. Reg. 60,410 (1980) (to be codified at 17 C.F.R. pt.240).

156. *Id.*

157. *Id.*

158. *United States v. O'Hagan*, 117 S. Ct. 2199 (1997), upheld this section of the Act as a proper extension of the statutes' intent.

159. See *Chiarella*, 445 U.S. 222, 248-51 (1980).

160. *Id.* at 251.

161. A remark attributable to Justice Blackmun in his dissent in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 762 (1975).

162. 664 F.2d 12 (2d Cir. 1981).

purchasing shares in tender offer target companies based on undisclosed information about pending, but secret, mergers and acquisitions.¹⁶³

Although Newman was not an employee of either investment banking firm, the SEC charged that he was liable because he "aided, participated in and facilitated Courtois and Antoniu in violating the fiduciary duties of honesty, loyalty and silence owed directly to Morgan Stanley, Kuhn Loeb, and clients of those investment banks."¹⁶⁴ This language suggested that an employee's act of fraud constitutes a 10b-5 violation. It was an attempt to remedy the deficiency noted by the Supreme Court in *Chiarella*, where the government failed to charge that *Chiarella* violated a duty to anyone other than the sellers of stock in the target companies.¹⁶⁵

On appeal by the United States, the Second Circuit reversed a lower court dismissal and remanded the case.¹⁶⁶ On the basis of the misappropriation theory, the court stated that Newman and his cohorts had, in effect, defrauded and "stolen" (again, Chief Justice Burger's term)¹⁶⁷ the information entrusted to them. As viewed by the court: "By sully[ing] the reputations of [defendant's] employers as safe repositories of client confidences, [Newman] and his cohorts defrauded those employers as surely as if they took their money."¹⁶⁸ The Second Circuit interpreted § 10(b) to encompass virtually any activity that could be described as operating as a "fraud or deceit upon any person 'in connection with the purchase or sale of any security.'"¹⁶⁹

Newman represented an expansion of the earlier case law in three important respects.¹⁷⁰ First, the Supreme Court had established that not every

163. Newman received nonpublic information about several merger and tender offer targets from E. Jacques Courtois, Jr. and Adrain Antoniu, employees of the investment banking firms of Morgan Stanley & Co., Inc., and Kuhn Loeb & Co., respectively, who had misappropriated the information from their employers. Newman, thus a tippee, then passed this information on to two of the other defendants who purchased stock of the target companies. After the plans were publicly disclosed, the price of the target companies increased, and the defendants sold their stock at a profit. *Id.* at 15.

164. *Id.* at 16.

165. The lower court dismissed the indictments because Newman had not breached such a duty, holding that "there was no 'clear and definite statement' in the federal securities laws which both antedated and proscribed the acts alleged in (the) indictment" such as to give Newman a reasonable opportunity to know that, absent an independent duty to disclose the nonpublic information his conduct would constitute fraud under Section 10(b) or Rule 10b-5. *Id.* at 14. The district court found that Newman was not under an independent duty to disclose the pending takeovers to shareholders of the target companies and therefore lacked the special relationship with the shareholders of the affected corporation as required by the SEC in *Cady, Roberts* to give rise to such a duty. Indeed, it is doubtful that the companies would have listened to such an outsider calling to reveal some secret data.

166. *Id.* at 12.

167. See *Chiarella v. U.S.*, 445 U.S. 222, 245 (1980).

168. *Newman*, 664 F.2d at 17 (citations omitted).

169. *Id.*

170. See David M. Brodsky, *A Critique of the Misappropriation Theory of Insider Trading*, SB93 ALI-ABA 105, 123-24 (1977), for a good description of these points.

instance of fraud would constitute a violation under § 10(b) or Rule 10b-5—in other words, it was necessary that some element of deception, misrepresentation or nondisclosure be present.¹⁷¹ Second, the court had held that federal securities laws required that the victim be a purchaser or seller of securities, not just an employer.¹⁷² Third, the court expanded § 10(b)'s requirement that the fraudulent activity be “in connection with” the purchase or sale of securities.¹⁷³

The Second Circuit's view of the composition of the U.S. Supreme Court in *Chiarella* became critical to its own holding. Relying on the fact that the higher court's *Chiarella* majority did not specifically rule on the feasibility of the misappropriation theory and that Chief Justice Burger's dissent seemed to have at least four, or possibly five, proponents, the Second Circuit basically determined that Newman's cohort's misappropriation of information from their employers constituted fraud.

The opinion did not answer the open issue concerning nondisclosure that occupied the majority in *Chiarella*—the question whether the obligation to refrain from trading is consistent with the fact that none of the defendants were under a duty to disclose to the sellers of a target company's securities that a takeover attempt was about to occur. Nor did the *Newman* decision discuss the implications of *Chiarella*'s holding that when an allegation of fraud is based on nondisclosure, it must be rejected without a duty to speak.¹⁷⁴

Under this view of the misappropriation theory, virtually any variety of fraud that has even a remote connection to the purchase or sale of securities could constitute a violation of § 10(b) or Rule 10b-5.¹⁷⁵ The effect of *Newman*'s holding was to transform § 10(b) and Rule 10b-5 from bans against securities fraud into general prohibitions against unfairness in the securities marketplace: a position that the Supreme Court seemed to explicitly reject in *Chiarella* and later decisions.

b. *SEC v. Materia*

With no response from the Supreme Court to *Newman*, four years later the Second Circuit decided *SEC v. Materia*,¹⁷⁶ a case very similar to *Chiarella*. The

171. See, e.g., *Blue Chip Stamps v. Manor Drug Store*, 421 U.S. 723 (1975).

172. *Id.* at 742.

173. *Newman*, 664 F.2d at 18.

174. This reference is to the common law definition of fraud by silence. The *Newman* court, however, fashioned a variety of securities fraud out of a breach of duty to a person (the investment banking firms, or their clients, the acquiring companies) other than a purchaser or seller of securities in the target companies. In *Newman*, even though the fraud was not against persons in their capacities as purchasers or sellers, the court held that the “in connection with” requirement was met based on a finding that Newman's sole purpose in misappropriating the information was to purchase stock in the target companies. The *Newman* court shifted the analysis under § 10(b) away from the defrauded purchaser or seller of securities and focused attention on the trader's relationship to the entity from which the information was obtained.

175. Earlier in *Superintendent of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12–13 (1971), the Supreme Court described the “in connection with” test as being satisfied if the fraud “touches” the investor's purchase or sale of securities.

176. 745 F.2d 197 (2d Cir. 1984).

court again used the misappropriation theory to find a financial printing company's employee liable for trading on information he obtained in the course of his employment.¹⁷⁷

The SEC filed an enforcement action, charging that *Materia* violated § 10(b) and § 14(e), Rule 10b-5 and the newly created Rule 14e-3 by trading on material, nonpublic information that he misappropriated from his employer and his employer's clients.¹⁷⁸ The district court agreed, holding that he breached a fiduciary duty owed to those parties. It enjoined *Materia* against future violations and ordered him to repay almost \$100,000 in profits.

Relying on *Newman*,¹⁷⁹ the court held that the defendant's breach of his duties of loyalty and trust to his employer was sufficient to impose liability, stating that "[O]ne who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his advantage violates § 10(b) and Rule 10b-5."¹⁸⁰

With *Newman* and *Materia*, the Second Circuit voiced its acceptance of the "misappropriation theory" as a viable weapon for imposing insider trading liability. Moreover, its language remarkably presages Justice Ginsberg's recent *O'Hagan* majority opinion. Thus Rule 10b-5 was broadened to cover both breaches against nonmarket participants and breaches of duties outside of the employment context. Thereafter, the theory was accepted by some courts outside the Second Circuit.

c. The Supreme Court Does Not Back Down

In 1983, Justice Powell wrote the last of his three decisions, *Dirks v. SEC*,¹⁸¹ restricting § 10(b). The SEC sued *Dirks* for violating Rule 10b-5, arguing

177. Like Vincent Chiarella, Anthony *Materia* was employed by a firm specializing in the printing of financial documents. *Materia*, like Chiarella, uncovered the identities of at least four tender offer targets from coded documents he handled at work. Subsequently, *Materia* purchased stock in those companies and sold the stock for a substantial profit after the offers were made public. These two cases seemed to be "on all fours."

178. See *Materia*, 745 F.2d at 199-200.

179. See *Newman*, 664 F.2d at 14.

180. See *Materia*, 745 F.2d at 203.

181. *Dirks v. SEC*, 463 U.S. 646, 648 (1983). *Dirks* was an officer of a New York brokerage firm which specialized in providing investment analysis to institutional investors of insurance companies securities. He received information from Ronald Secrist, a former officer of Equity Funding of America, a New York Stock Exchange company *Dirks* was researching. Secrist alleged that Equity Funding was involved in overstating assets and other fraudulent corporate practices. Acting as a precursor to today's whistle blower, Secrist noted that various regulatory agencies had failed to respond to this information. He urged *Dirks* to verify the fraud and disclose it publicly. *Dirks* then confirmed this information by talking to other former and present officers of the company. While his investigation was ongoing, *Dirks* discussed the information he had with the SEC and the *Wall Street Journal*, both of which also declined to act. Although neither *Dirks* nor his firm traded on the information, some of his clients with whom he had discussed the information, including five investment advisors, promptly sold holdings worth over \$16 million dollars, avoiding major

that Dirks was guilty by repeating the allegations of fraud to members of the investment community who later sold their Equity Funding stock.¹⁸² The Supreme Court rejected this theory,¹⁸³ again reversing the Court of Appeals. It held that Dirks had not violated Rule 10b-5 because he had no duty in this fact situation to abstain from the use of the inside information he had obtained.¹⁸⁴

Consistent with *Chiarella*, and again rejecting the "equal access to the stock market" rationale, the majority articulated the circumstances in which an outside tippee may violate Rule 10b-5 by trading on information obtained from an inside tipper.¹⁸⁵ The court cited a two-step approach.

First, the insider (tipper) himself must have breached his own fiduciary duty of confidentiality to his firm in disclosing the information to the tippee. Whether the disclosure is a breach of duty depends on the purpose of the disclosure. If the insider will personally benefit directly or indirectly from the disclosure, then there is a breach. Absent personal gain (albeit not necessarily pecuniary), the insider does not breach his fiduciary duty by disclosure of material, nonpublic information to a person who either trades on that information or gives it to others who trade on it, thus leaving the scienter requirement intact.¹⁸⁶

Second, the tippee must know or have reason to know that the insider breached his fiduciary duty by disclosing the information. If these two steps are shown, the tippee will inherit the insider's duty and be found liable. As stated by the court, the tippee's obligation arises as a "participant after the fact" in the insider's breach. Secrist was merely a whistle blower with good intention and did not breach a duty.¹⁸⁷ Thus, neither did Dirks.

Lastly, in addition to the "tipper/tippee" analysis, the Supreme Court set forth, in the now famous footnote fourteen of its opinion, the definition of a "constructive" insider.

[W]here corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is...[if] they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. When such a person

losses when the fraud was revealed and the stock plummeted.

Over the two-week period that Dirks pursued his investigation and spread word of Secrist's charges, the price of Equity Funding stock fell from \$26 a share to \$11 per share. This led the New York Stock Exchange to halt trading. Shortly thereafter, California insurance authorities uncovered evidence of fraud by Equity Funding. Only then did the SEC file a complaint against the firm.

182. *Id.* at 655-56.

183. *Id.* at 656-57.

184. *Id.* at 665-67.

185. *Id.* at 660-64.

186. *Id.* at 654, 660-64.

187. *Id.* at 655, 660.

breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee.¹⁸⁸

The Supreme Court essentially said that even temporary relationships can create a fiduciary relationship to a corporation, and trades or tips based on information acquired during that time are violations of Rule 10b-5.

d. Aftermath of *Chiarella* and *Dirks*: The Effect of the Court's Narrow Approach

The *Chiarella* and *Dirks* decisions limited insider trading liability to two groups: traditional corporate insiders and tippees of insiders who knew that the insider was receiving a personal benefit from the tip (for example, the tippee paid the insider for the tip). Unlike the "equal access to the stock market" test, this fiduciary duty standard adopted by the Court did not protect market participants generally by promoting equal access to material information by all participants.¹⁸⁹ Some examples soon followed showing the limits of guilty behavior.

In *SEC v. Switzer*,¹⁹⁰ a federal district court absolved football coach Barry Switzer of liability under the *Dirks* standard when he acted only as an eavesdropper of material information on which he profited. The court held that his acquaintance had not breached a duty himself and no benefit accrued to the executive.¹⁹¹

In *United States v. Reed*,¹⁹² a federal district court used *Dirks* to acquit a son who acted on material insider information told to him by his father.¹⁹³ Under the "equal access" test used in *Texas Gulf Sulphur*,¹⁹⁴ both of these actions would

188. *Id.* at 655 n.14 (citations omitted).

189. See Richard M. Phillips & Robert J. Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 HOFSTRA L. REV. 65 (1984); Barbara Bader Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 120 (1984).

190. 590 F. Supp. 756 (W.D. Okla. 1984). Barry Switzer, then the coach of the University of Oklahoma football team, attended a high school track meet in which his son was competing. While allegedly sunbathing in the bleachers, he claimed to have overheard a high powered corporate executive and his wife, whom he knew, talking about some material good news affecting their publicly traded business. Immediately after hearing this information, Switzer organized a group of 30 people who purchased 36,000 shares of stock in the company's affiliate. After a favorable public announcement was made several days later, the group sold the stock, making a \$600,000 profit, and the SEC sued.

191. *Id.* at 762, 766.

192. 601 F. Supp. 685 (S.D.N.Y. 1985), *rev'd*, 773 F.2d 477 (2d Cir. 1985). The defendant learned from his father, a member of the board of directors of Amax Corporation, that the company had entered into nonpublic confidential discussions with another corporation for its acquisition at a premium price. The father testified that he gave his son this information in confidence with the expectation that it would not be disclosed. Instead, the defendant immediately purchased call options on Amax shares. Several days later, the merger was announced which contained an offer to purchase shares at more than double the trading price. On a relatively small investment, the defendant was able to make a \$700,000 profit.

193. *Id.* at 703.

194. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848-49 (2d Cir. 1968).

have resulted in convictions. The outsider defendants knew that they were acting on material, nonpublic information received from insiders. However, in neither case could it be shown that the insider tipper received a benefit from the disclosure. While lower courts and commentators debated the so-called misappropriation theory, the Supreme Court had yet to deal with it directly.¹⁹⁵

Chiarella disappointed securities law practitioners when the case turned on improper jury instructions and not the misappropriation theory. *Dirks* also failed to answer all questions on misappropriation because Secrist, the insider, was an innocent whistle blower. However, the parity of information and equal access rationales seemed to have been tabled. While this stopped the government from bringing prosecutions and enforcement actions based solely on this theory and from arguing that mere possession of nonpublic information created a duty to disclose or abstain from trading, it did not prevent a new, clever twist on this emerging theory. A person commits fraud, it was argued by the SEC, "in connection with" a securities transaction, and therefore violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes in breach of a duty he owes to the source of the information—not necessarily the issuer—but merely the tipper.¹⁹⁶

VI. THE DIVIDED COURTS

A. *The Second Circuit's Apogee with Misappropriation—United States v. Carpenter*

A dramatic expansion of the misappropriation theory occurred by the Second Circuit in *United States v. Carpenter*,¹⁹⁷ probably the most well known of the misappropriation theory cases.

In upholding a defendant's criminal convictions under Rule 10b-5 for using insider information which a journalist had obtained and used, the Second Circuit pointed out that the employer, The Wall Street Journal had a policy that information obtained in the course of employment belonged to the paper and was

195. See Brodsky, *supra* note 170, at 120; Alison Grey Anderson, *Fraud, Fiduciaries, and Insider Trading*, 10 HOFSTRA L. REV. 341 (1982).

196. How long this new rationale would go untested became the key question in the late 1980s. See, e.g., Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139 (1995); Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1193 (1995).

197. 791 F.2d 1024 (2d Cir. 1986). R. Foster Winans worked for the *Wall Street Journal* as a writer for its "Heard on the Street" column. Winans entered into a scheme to leak the timing and contents of future columns to Carpenter and others, days prior to publication so that they could purchase stocks before the column appeared. Winans also was charged with providing two stockbrokers at Kidder Peabody, Kenneth P. Felis and Peter Brant, with securities-related information that was scheduled to appear in the columns, information which the stockbrokers then used to buy or sell the subject securities. Over a relatively short period of time, the defendants were able to accumulate almost \$690,000 in profits.

required to be kept confidential (not unlike the posted warning sign in *Chiarella*). The writer breached this duty when he traded on the information for his own personal gain.¹⁹⁸

The court further noted that while there was no violation under *Dirks* because neither the writer nor the Journal owed a duty to those corporations which the reporter wrote about, *Dirks* was not controlling because it did not address the misappropriation theory.¹⁹⁹ Stressing the "broad remedial purposes of the securities laws," the court held that "misuse of corporate inside information is not the only type of fraud that the securities laws cover," but they apply to "all 'manipulative and deceptive practices which have been demonstrated to fulfill no useful function.'"²⁰⁰

B. The Supreme Court's Second Chance to Resolve the Issue

Once more, like in *Dirks*, the stage was set for the Supreme Court to finally rule on the misappropriation theory. Again, those following this law would be disappointed. The commentators and industry personnel fully expected Justices Rehnquist (author of *Blue Chip Stamps*), White (author of *Santa Fe Industries v. Green*) and Powell (author of *Ernst & Ernst, Dirks*, and *Chiarella*), to lead the court into a final rejection of this theory and yet another reversal of the Second Circuit.

Ironically, Justice White would write the *Carpenter*²⁰¹ opinion, but due to a quirk in timing in which Justice Kennedy was not yet seated, the Supreme Court, by a four-to-four vote, had to affirm the conviction of Carpenter under securities and mail fraud²⁰² laws. Without analysis of the Rule 10b-5 issues, Justice White simply indicated that the Court was evenly divided on whether misappropriation of property falls within the purviews of § 10(b) and Rule 10b-5 and placed his entire affirmation of the conviction on the mail fraud theory.²⁰³

The *Carpenter* case represented an exceptionally broad use of laws intended to prohibit insider trading in several respects. First, the information in the *Heard on the Street* columns was in no sense "inside" information. In fact, all of the information contained in the articles was public information. It was only the fact of publication, date of the columns, and general tenor of the articles, not their informational content, that was nonpublic. Second, the articles themselves were not published for the purpose of manipulating the price of the stock. Rather, the court found that the articles were accurate to the best of Winans' knowledge and the subject matter was chosen on the basis of journalistic merit. Finally, Winans was even more of an outsider than the defendants in other misappropriation cases,

198. *Id.*

199. *Id.* at 1028-29.

200. *Id.* at 1029-30.

201. *Carpenter v. U.S.*, 484 U.S. 19 (1987).

202. *See* 15 U.S.C. § 78j(b) (1994); 18 U.S.C. § 1341 (1994); 18 U.S.C. § 1343 (1994).

203. *Carpenter*, 484 U.S. at 25-28.

and the connection between Winans' "fraud" and the securities transactions that formed the basis of the conviction were much more tenuous.²⁰⁴

In contrast, the Wall Street Journal in *Carpenter* had no relationship with, and owed no duty to, any of the companies about which Winans wrote. Winans' misappropriation did not violate a duty owed to any party engaged in the securities transactions that formed the predicate for his conviction. It seemed to imply that any embezzlement from one's employer, where the employee later uses the proceeds to purchase stock, constitutes securities fraud. If so, it is difficult to understand how the goal of § 10(b) and Rule 10b-5—"to protect persons who are deceived in securities transactions"—was furthered by the application of the insider trading laws to these situations.²⁰⁵

The *Carpenter* decision also resulted in illogical distinctions concerning who may use the same information. Because the facts used in the article were public, anyone could have traded lawfully on the basis of the facts presented in them. Had Winans chosen not to write an article about a particular company, he apparently could have traded in that company's stock using the information obtained for the article.

Moreover, Winans' wrongful conduct was based entirely on the Journal's internal policy that deemed all materials gleaned by an employee during the course of employment to be company property, and required employees to treat nonpublic information learned on the job as confidential.²⁰⁶ If the Journal had had no such policy, Winans would not have been deemed to have violated the federal securities laws. It also would seem that Dow Jones & Co., owner of the Journal, could, itself, have traded on advance knowledge of the articles without violating the federal securities laws because the Journal could not logically misappropriate its own property.²⁰⁷

While the Supreme Court was forced to affirm the Second Circuit convictions on both counts, it had said earlier, "an affirmance by an evenly divided

204. In both *Newman* and *Materia* the employers were temporary insiders of their clients, the acquiring companies, and owed those companies a duty of loyalty and confidentiality. These duties passed on to their employees, *Newman*'s cohorts and *Materia*. Although *Newman* and *Materia* can be criticized for applying liability under § 10(b) where the defendants owed no duty to the issuer corporation's shareholders and the fraud was not perpetrated against the buyer or seller of securities, at least those cases identified a duty running between defendants and entities connected in some way to the securities transaction from which they are alleged to have wrongly profited.

205. See *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930, 943 (2d Cir. 1984). (Friendly J.) (Justice Friendly indicated a negative view toward the implied private cause of action in TGS, holding that misrepresentation or omission involved in a securities transaction that does not pertain to the value of the securities cannot form the basis of a § 10(b) violation.).

206. *Carpenter*, 484 U.S. at 25-28.

207. This result indicated yet another extension of *Newman* and *Materia* in which it also would have been unlawful for the defrauded employers, Morgan Stanley & Bowne Printing Co., respectively, to have traded on the basis of the misappropriated information. These are strange results indeed for a theory designed to bring about greater information equality.

court [is not] entitled to precedential weight."²⁰⁸ Thus, ultimate judicial support for the misappropriation theory was still inconclusive.

C. Subsequent Expansion Within the Second Circuit

The Second Circuit's decision in *Carpenter* constituted a huge doctrinal leap from criminalizing breaches against market participants to a broader universe of nonmarket participants. While *Carpenter* was in the context of employment, other courts extended the misappropriation theory to criminalize breaches of duties in contexts in which the expectations of the parties were very different from an employer/employee relationship.

1. United States v. Reed—A Reprise

Recall that in *Reed*,²⁰⁹ the court held that a son's breach of a trust relationship with his father was sufficient basis for a § 10(b) indictment. The court looked to the common law regarding confidentiality and determined that a familial relationship was the type whose breach in connection with the purchase or sale of securities created criminal liability under § 10(b). Rejecting a narrower view of the breach of the securities laws, the Second Circuit held that the concept of confidential relationship is, by nature, flexible and defiant of precise definition.²¹⁰

2. United States v. Willis

In *Willis*,²¹¹ the misappropriation theory was held to encompass a psychiatrist's use of information revealed by a patient.²¹²

A federal district court convicted a doctor who used material insider information obtained from a patient about her husband's business. Relying on the *Carpenter*²¹³ decision, the court reiterated that the critical relationship "is the one between the misappropriator and the person to whom the misappropriator owes a fiduciary duty, and not the relationship between such person and any insider source of the information."²¹⁴

This rule, the court reasoned, is based on the misappropriation theory's focus on "the relationship between the misappropriator and the person to whom he

208. Neil v. Biggers, 409 U.S. 188, 192 (1972).

209. 601 F. Supp. 685 (S.D.N.Y. 1985), *rev'd*, 773 F.2d 477 (2d Cir. 1985).

210. *Id.*

211. 737 F. Supp. 269 (S.D.N.Y. 1990).

212. *Id.* at 274-75. The wife of prominent executive Sanford Weill told her psychiatrist, Dr. Robert Willis, about her husband's efforts to become CEO of Bank of America. Willis made a profit by purchasing shares in Bank of America prior to the public announcement of Weill's effort, and selling them a day later. The district court upheld the indictment which was premised on the misappropriation theory.

Willis initially pled guilty to charges that he violated § 10(b) under the misappropriation theory, however, after the *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991) decision.

213. See *Willis*, 737 F. Supp. at 274-75.

214. *United States v. Willis*, 778 F. Supp. 205, 208 (S.D.N.Y. 1991).

owes an obligation of confidentiality,"²¹⁵ not that the breach of a duty relates to a corporation or its shareholders. The court found that the relationship of importance was that of the doctor and patient, not the husband and wife, and denied this contention.

In addressing Willis' second argument, the court looked at what was contemplated by a fiduciary relationship, specifically, "[a] fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests."²¹⁶ Further,

in relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use.²¹⁷

The court easily found a fiduciary relationship based on Willis' oath of confidentiality to his patients as a doctor, because "the patient depends on the psychiatrist to serve her interests."²¹⁸

In this aspect the patient may entrust the psychiatrist with the custody of material, nonpublic information that the psychiatrist is now duty bound to not employ.²¹⁹ Therefore, Willis did misappropriate the information that he learned from his patient, and he subsequently had a duty to either disclose his superior information prior to trading or abstain from trading altogether. Because he failed to reveal his superior information prior to its use, the court denied Willis' second contention.

The *Willis* decision not only reaffirmed the misappropriation theory, but actually expanded it by endorsing a specific type of fiduciary relationship that satisfies the theory. This is contrary to what the court in *Chestman* had desired, as the *Willis* court further removed the misappropriation theory from the securities market.²²⁰ Thus, due to the broad interpretation of insider trading laws, *Willis* fell within the reach of §10(b) and Rule 10b-5.

The Second Circuit²²¹ did not address the significant shift it was making by bringing the physician/patient relationship within the purview of the federal securities laws. Instead, the court focused on the confidential nature of such relationships, explaining that "it was difficult to imagine a relationship that requires a higher degree of trust and confidence...."²²²

215. *Id.* at 209.

216. *Id.*

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* Four separate opinions were generated based upon the facts of this case; however, only the two cited are relevant to this analysis. 778 F. Supp. 205, (S.D.N.Y. 1991); 737 F. Supp. 269 (S.D.N.Y. 1990).

222. *United States v. Willis*, 737 F. Supp. 269, 272 (1990).

3. United States v. Chestman

Then in *Chestman*,²²³ the en banc Second Circuit reviewed the conviction of a stockbroker, Robert Chestman, who profited from information heard from a customer concerning a business owned by his wife's family.

Voting five to five with one abstention, the Second Circuit upheld Chestman's convictions under Rule 14e-3(a), but reversed those under § 10(b).²²⁴ The court held that Loeb's relationship with his wife's family was not a fiduciary one. However, the court distinguished Chestman's case from *Reed*²²⁵ because, in the latter, there were repeated disclosures between father and son of business secrets that that court believed was enough to find a breach of a familial duty leading to a § 10(b) violation.²²⁶

D. Acceptance of the Doctrine in Other Circuits

In the years following the Second Circuit's adoption of the misappropriation doctrine, the theory was argued to courts in other jurisdictions and was "welcomed by circuit and district courts alike."²²⁷ Following the lead set by the Second Circuit in *Newman*, the Third Circuit indicated a willingness to follow the misappropriation theory in *Rothberg v. Rosenbloom*.²²⁸ The trial court found that liability was established because of a breach of duty to his corporation, thereby establishing a violation under the analysis in *Newman*. The Third Circuit affirmed²²⁹ and other courts soon followed.

In 1990, the Ninth Circuit in *SEC v. Clark*²³⁰ adopted the same definition of the misappropriation theory developed by the Second Circuit. A jury acquitted

223. 947 F.2d 551 (2d Cir. 1991). Keith Loeb, a client, informed Chestman that his wife, a member of the Waldbaum family, which owned the Waldbaum supermarket chain, had told him that a controlling block of Waldbaum shares would soon be sold to another company, A & P. Thereupon, Chestman purchased Waldbaum stock for his own account and for the accounts of several clients, including Keith Loeb. After A & P's tender offer was publicly announced, the price of the Waldbaum stock nearly doubled. An investigation into the transactions in the stock ensued, and Loeb cooperated with the government. Chestman was indicted for securities fraud and was eventually convicted by a jury.

224. *Id.* at 571.

225. *U.S. v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985), *rev'd*, 773 F.2d 477 (2d Cir. 1985). See *supra* text accompanying notes 209–10.

226. *Id.* at 709–13.

227. *SEC v. Clark*, 915 F.2d 439, 448 (9th Cir. 1990).

228. 771 F.2d 818 (3d Cir. 1985), *rev'd on other grounds*, 808 F.2d 252 (3d Cir. 1986). *Rothberg* involved investors who were also board members of certain companies and purchased stocks based on material nonpublic information. In two instances, Rothberg bought shares in a publicly known target company without disclosing material nonpublic information and was convicted of violating § 10(b). In *Rothberg*, the court does not explicitly mention the misappropriation theory but makes reference to *Newman*. See *id.* at 822.

229. *Id.* at 824.

230. 915 F.2d 439 (9th Cir. 1990). Clark was a member of a medical supply company's acquisition team. In this capacity, Clark knew of a proposed takeover and

the broker but found that Clark violated Rule 10b-5 by misappropriating and trading on material, nonpublic information. On appeal, the *Clark* court stated that "the misappropriation theory fits comfortably within the meaning of 'fraud' within § 10(b) and Rule 10b-5...[as long as the fraud is] 'in connection with the purchase or sale of any security.'"²³¹

In a somewhat extraordinary conclusion, the Ninth Circuit further held that Clark, the employee, could be required to repay the profits made by his stockbroker (who also traded without disclosure of the material nonpublic information provided by Clark), even though the stockbroker was not found by the jury to have violated any federal securities laws.²³²

The following year, the Seventh Circuit relied on *Clark*, *Rothberg*, and *Newman* in support of its own adoption of the misappropriation theory in *SEC v. Cherif*.²³³ The court found that a person violates § 10(b) and Rule 10b-5 when he trades on material nonpublic information that was misappropriated in a breach of a fiduciary relationship such as employment.²³⁴

Thus, the Second, Third, Seventh, and Ninth Circuits had all adopted the misappropriation theory in substantially the same form. Each Circuit accepted the rationale of *Newman*, and each built on the precedent established by the other circuits. In all of those opinions, § 10(b) and Rule 10b-5 are violated when one misappropriates material nonpublic information in the breach of a fiduciary duty or

directed his stockbroker to purchase two thousand shares of the target company. From these purchases, Clark realized profits of over \$47,000 and his broker gained over \$7500.

231. *Id.* at 449.

232. This rationale had its precursor in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (1968). When that matter was retried upon remand, the previously convicted company geologist Mr. Darke, was then ordered to pay to his former employer (Texas Gulf) an amount equal to all of the profits which his tippees made on their own sales of the stock based on his advice. On this point, the court stated:

As to the requirement that Darke make restitution for the profits derived by his tippees, admittedly more of a hardship is imposed. However, without such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.

SEC v. Texas Gulf Sulphur Co. 446 F.2d 1301, 1308 (1971), *cert. denied*, 404 U.S. 1005 (1971).

Subsequent decisions also held that full restitution (again the inflammatory word "disgorgement" is used) may be obtained from tippees as well as their insider-tippers. *SEC v. Lund*, 570 F. Supp. 1397, 1399 (C.D. Cal 1983).

233. 933 F.2d 403 (7th Cir. 1991). Cherif was an employee of First National Bank of Chicago. When his position was eliminated due to reorganization, Cherif kept his magnetic office access card which he managed to keep activated. In knowing violation of an "integrity policy" Cherif signed while still an employee, he misappropriated material, nonpublic information about tender offers after his employment was terminated. Cherif made substantial profits while trading on the misappropriated nonpublic information.

234. *Id.* at 410.

similar relationship of trust or confidence and uses that information in connection with a securities transaction.²³⁵

These decisions are noteworthy not just for their snowballing effect but also for the minimal scrutiny applied when considering the theory's legitimacy. The opinions rely on *Newman* without considering its long term implications, declining to revisit the "issues of statutory construction and legislative history" raised by the misappropriation theory because these issues had been addressed by the other courts. Most interestingly, the U.S. Supreme Court denied certiorari in every one of them. The courts thus remained divided,²³⁶ but why the Court continuously denied certiorari in cases needing an ultimate resolution while hearing those involving traditional 10b-5 arguments was unclear.

Before proceeding to *O'Hagan*, it is instructive to review two Supreme Court Rule 10b-5 decisions announced in the midst of this lower court split on the viability of the misappropriation doctrine. *Basic Inc. v. Levinson*²³⁷ and *Central Bank of Denver v. First Interstate Bank of Denver*,²³⁸ became two conflicting opinions determined, like *Carpenter*, by the philosophy and composition of the Justices then seated on the High Court.²³⁹

E. Justices Blackmun and White: The Tables Are Turned for a Moment

*Basic Inc. v. Levinson*²⁴⁰ was decided in 1988, just one year after the court voted four to four to uphold *Carpenter*'s conviction, a case in which Justice Kennedy was not yet seated.²⁴¹ Following years of writing the dissents in this area, Justice Blackmun would now get his opportunity. He formulated a four to two plurality opinion which essentially affirmed the *Texas Gulf Sulphur* doctrine. This unique composition of the court occurred because Chief Justice Rehnquist, Justice

235. In *United States v. Libera*, 989 F.2d 596 (2d Cir. 1993), the Second Circuit did hold tippees liable for receiving early editions of *Business Week* and trading its news before the magazine hit the newstands.

236. See *Cherif*, 933 F.2d at 403; *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985), *rev'd on other grounds*, 808 F.2d 252 (3d Cir. 1986), *cert. denied*, 481 U.S. 1017 (1987); *United States v. Newman*, 664 F.2d at 12 (1981), *cert. denied*, 464 U.S. 863 (1983).

237. 485 U.S. 224 (1988).

238. 511 U.S. 164 (1994).

239. These holdings set the stage for the decision on the validity of the misappropriation theory which the court would finally render in *O'Hagan*.

240. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

241. Most SEC observers expected that Justice Kennedy would have voted to reverse the convictions. See, e.g., Troy Cichos, *The Misappropriation Theory of Insider Trading: Its Past, Present, and Future*, 18 SEATTLE U. L. REV. 389, 391 (1995); Hall, *supra* note 5; Kim Lane Scheppele, "It's Just Not Right": *The Ethics of Insider Trading*, 56 LAW & CONTEMP. PROBS. 123, 123 (1993); William K.S. Wang, *The "Contemporaneous" Traders Who Can Sue an Insider Trader*, 38 HASTINGS L.J. 1175 (1987); Christine Marra, Note, *The Misappropriation Theory: A Practical Means of Imposing Rule 10b-5 Liability*, 24 U. RICH. L. REV. 211, 211 n.1 (1990). Cf. HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

Scalia and, again, Justice Kennedy took no part in the consideration or decision of the case.²⁴²

Blackmun said that certain corporate press releases regarding a possible merger were misleading by omitting the details of the transaction and thus, the defendant company committed a "fraud on the marketplace."²⁴³ This made the burden of proof for the plaintiff extremely easy, creating a rebuttable presumption of reliance and causation by people who traded—even if they never knew who the defendant was before the litigation.

Basically the Court held that (1) the standard of materiality in an earlier case, *TSC Industries*,²⁴⁴ was appropriate in a § 10(b) and Rule 10b-5 context; (2) "materiality" in mergers depends upon the probability that the transaction will be consummated,²⁴⁵ and (3) there is a presumption of reliance when a "fraud-on-the-market" occurs, although the presumption is rebuttable.²⁴⁶ In reality, this presumption of reliance and even causation was virtually absolute for those who innocently trade if others possess inside information;²⁴⁷ a major shift to assist the prosecution. While not a misappropriation case, the underlying doctrines of "equal access," "fraud on the market," and even "fairness" were characterized in broad, pro-plaintiff terms.²⁴⁸ This case, along with the Supreme Court's four to four decision in *Carpenter* set the stage for subsequent cases in the 1990s Court.²⁴⁹

242. The dispute in *Basic* developed out of a merger agreement between Basic, Incorporated and Combustion Engineering Corp. For two years, representatives of the two companies had various meetings and conversations regarding the possibility of a merger. Over that time, Basic made three public denials, indicating that while it was involved in merger negotiations, it considered them minor and did not refer to their nature or status.

After the suspension of the trading of Basic stock due to extraordinary volume just prior to the actual merger, former Basic shareholders who had sold their stock following Basic's first public denial filed a class action against Basic and its directors for violations of § 10(b) and Rule 10b-5. Since the company's press releases had not described the nature and extent of the merger discussions, individual plaintiffs who bought or sold during that time claimed that they would have done something differently had they known the details of the merger. Because Justices Rehnquist, Kennedy, and Scalia did not participate for undisclosed reasons, Justice Blackmun was able to persuade three other Justices to join in his opinion upholding this class action 10b-5 case.

243. *Basic*, 485 U.S. at 248.

244. *Id.* at 231 (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438 (1976)).

245. *Id.* at 238.

246. *Id.* at 246.

247. Ironically, although espousing a philosophy of giving all investors equal access to information in an efficient market, Justice Blackmun did not offer any guidance of when a company must disclose merger negotiations. He suggested that "No Comment" may be a better response. Yet that approach would result in no information being distributed out of caution; the exact opposite of creating a "market of equal access." *Id.* at 239 n.17.

248. *Id.* at 228-30.

249. In the strong-worded dissent, Justices White and O'Connor said that it would be absurd for a company to have to disclose every time it had the slightest possibility or interest in a particular transaction. The marketplace would be flooded with data and therefore rumors. They suggested that the information needs to be "material," which means that the merger has to be at an "agreement in principle" stage, to avoid speculation.

F. Justice Kennedy's Turn to Take a Stand

Central Bank of Denver v. First Interstate Bank of Denver,²⁵⁰ was a last moment of triumph for those seeking to limit 10(b). The Supreme Court in *Central Bank* overturned several circuit courts by eliminating the private cause of action against those allegedly aiding and abetting a violation of Rule 10b-5.

Speaking through Justice Kennedy, whose absence from the *Carpenter* and *Basic* cases materially influenced their outcomes, the court applied a strict textual interpretation to the Securities Act and found that while § 10(b) prohibits the making of material misstatements or the omission or commission of manipulative acts, it does not prohibit the giving of aid to one who commits the manipulative or deceptive act.

The Tenth Circuit concluded that to find a violation of § 10(b) for "aiding and abetting," one needed: (1) a primary violation of § 10(b); and (2) recklessness by the aider and abettor.²⁵¹ Applying the standard, the court found that a guarantor bank's officers were aware of an inflated appraisal which led investors to purchase bonds which later defaulted. The court found that the alleged inadequacies in the appraisal raised issues of material fact regarding the recklessness element needed to establish liability for "aiding and abetting" a Rule 10b-5 violation.²⁵²

The bank's petition for certiorari on the issues of whether it could be liable as an aider and abettor without a breach of the indenture agreement and

250. 511 U.S. 164 (1994). In *Central Bank*, the local Public Building Authority in 1986 issued \$26 million in bonds to finance public improvements in Stetson Hills, a planned residential and commercial development in Colorado Springs. Central Bank served as an indenture trustee for the bonds, which were secured by landowner assessment liens. A key covenant required that the land subject to the lien had to be worth at least 160% of the value of the bonds' outstanding principal and interest amount. The developer, AmWest Development, was to provide Central Bank with an annual report demonstrating that the 160% requirement was fulfilled.

Two years later, Central Bank received AmWest's updated appraisal of the land securing the bonds. Upon reviewing the report, the underwriter wrote to Central Bank expressing a concern as to falling real estate prices in the area and that Central Bank was operating on appraisal values over sixteen months old. Thereafter, Central Bank's in-house appraiser reviewed the updated appraisal and concluded that the figures were optimistic. He suggested that an outside appraisal be independently conducted. After an exchange of letters between Central Bank and AmWest, Central Bank agreed to delay the appraisal until the end of the year. The Authority then defaulted on the bonds before the independent review was completed.

As a result of the default, First Interstate Bank and the individual purchasers of the bonds sued the Authority, the underwriter, a junior underwriter, an AmWest director and Central Bank for violation of § 10(b). First Interstate alleged, among other things, that Central Bank was secondarily liable for aiding and abetting the fraud committed by the bond issuer and underwriters because of its overvalued appraisal. The United States District Court for the District of Colorado granted summary judgment to Central Bank. However, the Tenth Circuit reversed, holding that the defendant's conduct was reckless, and "recklessness" was a sufficient basis for aiding and abetting liability under § 10(b). *Id.* at 167-68.

251. *Central Bank of Denver v. Pring*, 969 F.2d 891 (10th Cir. 1992).

252. *Id.* at 898.

whether recklessness was sufficient for liability was granted. However, the U.S. Supreme Court also directed the parties to address in their briefs an additional threshold question of whether there was a federal, private right of action for aiding and abetting a violation of § 10(b).²⁵³

When it heard the case, the Supreme Court concluded that no such right existed. Justice Kennedy emphasized that the scope of conduct prohibited by § 10(b) is controlled by a strict reading of the text of the statute. The "aiding and abetting" argument must fail because the allegations of fraud were not "in connection with" the sale or purchase of securities.²⁵⁴

The Court basically affirmed *Ernst & Ernst v. Hochfelder*²⁵⁵ for support of a strict statutory construction of § 10(b). In *Ernst & Ernst*, the Court had required scienter as opposed to mere negligence because the statutory language of § 10(b) strongly suggested that the conduct intended to be proscribed was "knowing" and "intentional," adding that if it was to only require negligence, it would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning."²⁵⁶ In essence, the Court in *Ernst & Ernst* utilized a strict interpretation of § 10(b) and Rule 10b-5 to undermine additional meanings to § 10(b) and Rule 10b-5 violations.²⁵⁷

Relying on the strict construction analysis provided in *Ernst & Ernst*, the *Central Bank* Court found that "the statutory text controls the definition of conduct covered by § 10(b)."²⁵⁸ The Court went further stating that "the language of § 10(b) does not in terms mention aiding and abetting"²⁵⁹

First Interstate argued that while the text of § 10(b) does not specifically refer to aiding and abetting liability, the phrase "directly or indirectly" covers such acts. The Court held that the statutory silence rejects the conclusion despite the findings of several Courts of Appeals to the contrary.²⁶⁰ The Court also justified its narrow reading of § 10(b) in part by relying on the fact that the securities market is "an area that demands certainty and predictability."²⁶¹ The Court found that broad and unclear interpretations of § 10(b) create "uncertainty and excessive litigation."²⁶²

The guidelines provided in *Central Bank* for interpreting § 10(b) liability become especially important when analyzing the viability of new theories such as misappropriation. That theory appears, on its face, to be a stretch of the boundaries of statutory construction. Under the analysis provided in *Central Bank*, it appeared

253. 508 U.S. 959 (1993).

254. *Central Bank*, 511 U.S. at 173.

255. 425 U.S. 185 (1976).

256. *Id.* at 199.

257. *Id.*

258. *Central Bank*, 511 U.S. at 175.

259. *Id.* at 175.

260. *Cleary v. Perfectune, Inc.*, 700 F.2d 774 (1st Cir. 1983); *Kerbs v. Fall River Industries*, 502 F.2d 731 (10th Cir. 1974); *Brennan v. Midwestern United Life*, 259 F. Supp. 673 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

261. *Central Bank*, 511 U.S. at 188.

262. *Id.* at 189.

that the misappropriation theory would not hold up if heard by the Supreme Court. Thus, despite the split between the Fourth and Eighth Circuits which rejected the misappropriation theory and the Second, Seventh, and Ninth Circuits that accepted it, the Supreme Court still did not act.

G. Rejected by Fourth and Eighth Circuits

Although the misappropriation theory enjoyed nearly one decade of federal court approval, the Fourth Circuit in *United States v. Bryan*,²⁶³ and more recently, the Eighth Circuit in *United States v. O'Hagan*,²⁶⁴ denied its legitimacy. In *Bryan*, the court held that the misappropriation theory had no foundation in law and was not a viable theory of liability.²⁶⁵ The counts included perjury as well as mail and wire fraud.²⁶⁶ In *O'Hagan*, the Eighth Circuit adopted the totality of the reasoning of the *Bryan* court. A closer examination of these lower court decisions sets the stage for the surprising recent reversal by the Supreme Court.

The misappropriation theory was an issue of first impression before the Fourth Circuit. The court concluded that nothing in the statutory language of § 10(b) or Rule 10b-5 or in the Supreme Court authorities interpreting those provisions supported the validity of the misappropriation theory. In arriving at this conclusion, the *Bryan* court stated that § 10(b) "prohibits only the use of deception, in the form of material misrepresentations or omissions, to induce action or inaction by purchasers or sellers of securities, or that affects others with a vested interest in a securities transaction."²⁶⁷

The *Bryan* court went on to discuss and distinguish the misappropriation theory stating that if followed it would even create liability for mere breaches of fiduciary duty or similar relationships of trust and confidence. Such liability would attach "whether or not the breaches entail deception within the meaning of section 10(b) and whether or not the parties wronged by the breaches were purchasers or sellers of securities, or otherwise connected with or interested in the purchase or sale of securities."²⁶⁸ This was unacceptable to the court, which held that it still required other components when establishing criminal liability under § 10(b) and Rule 10b-5.²⁶⁹

263. 58 F.3d 933 (4th Cir. 1995).

264. 92 F.3d 612 (8th Cir. 1996).

265. See *United States v. Bryan*, 58 F.3d 933, 945-49 (4th Cir. 1995). Elton "Butch" Bryan was a director of the West Virginia lottery. In September of 1993, a federal jury in Charleston, West Virginia, found him guilty of securities fraud in violation of Rule 10b-5. The counts included perjury as well as mail and wire fraud.

266. The convictions arose from Bryan's manipulation of two government contracts and from his use of confidential, nonpublic information in the purchase of securities of companies doing business with the West Virginia lottery. *Id.* at 936.

267. *Id.* at 944.

268. *Id.*

269. The court stated that under the misappropriation theory, criminal liability is established when a person "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." *Id.*

The flaw in the theory, it concluded, is that it attempts to extend liability by allowing the "fraud" requirement of Rule 10b-5 to be satisfied by the misappropriation of nonpublic, material information in the breach of a fiduciary duty or similar relationship. Erroneously, the source of the misappropriated information need not be a buyer or seller of securities nor have any other interest in the sale or purchase of securities. The theory has been characterized as "fraud on the source" liability. As such, the misappropriation theory relies on the fraud against, and breach of duty toward, any person that is in any way related to a securities transaction;²⁷⁰ an insufficient doctrine as far as the Bryan court was concerned.²⁷¹

Relying upon the Supreme Court's statement in *Central Bank*²⁷² that the securities market "demands certainty and predictability," it criticized the misappropriation theory as injecting substantial uncertainty, writing that "although fifteen years have passed since the theory's inception, no court adopting the misappropriation theory has offered a principled basis for distinguishing which types of fiduciary or similar relationship of trust and confidence can give rise to Rule 10b-5 liability and which cannot."²⁷³

In addition, the court emphasized that the primary concern of § 10(b) was the protection of purchasers and sellers of securities, referring to Justice Rehnquist's warning in *Blue Chip Stamps*, that

[w]e believe that the concern expressed for the danger of vexatious litigation which could result from a widely expanded class of plaintiffs under Rule 10b-5 is founded in something more substantial than the common complaint of many defendants who would prefer avoiding lawsuits entirely to either settling or trying them.²⁷⁴

The *Bryan* court was essentially concerned with speculative damages from plaintiffs who could allege that they "would have" sold (or bought) shares had they known of the material, nonpublic information.²⁷⁵

270. *Id.*

271. The court went on to analyze the meaning of "manipulation," "deception," and "fraud," as basic requirements for § 10(b) and Rule 10b-5 liability. Holding that the fraud which Rule 10b-5 prohibits cannot be greater than that which § 10(b) proscribes, the Fourth Circuit looked to *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476 (1977), where the Supreme Court described "manipulation" as a term referring to "practices, such as wash sales, matched orders, and rigged prices, that are intended to mislead investors by artificially affecting market activity." See *Bryan*, 58 F.3d at 945. Such events did not occur in *Bryan*. The court analyzed the meaning of "deception" by referring to the Supreme Court's decision in *Central Bank*. See *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994), where it limited that term to the "making of a material misstatement (or omission) or the commission of a manipulative act." See *Bryan*, 58 F.3d at 946.

272. See *Central Bank*, 511 U.S. at 188.

273. *Bryan*, 58 F.3d at 951.

274. *Id.* at 952.

275. *Id.*

In the year following *Bryan*, the Eighth Circuit also rejected the misappropriation theory in *United States v. O'Hagan*.²⁷⁶ James O'Hagan was a partner in the law firm of Dorsey & Whitney in Minneapolis, Minnesota. In July of 1988, Grand Metropolitan PLC ("Grand Met"), a company based in London, England, retained Dorsey & Whitney as local counsel to represent Grand Met regarding a potential tender offer for the common stock of the Pillsbury Company, headquartered in Minneapolis. O'Hagan did not do any work on the representation of Grand Met.²⁷⁷ However, he had a major problem—he had embezzled almost \$1,000,000 from a client's trust account.²⁷⁸

On August 18, 1988, while Dorsey & Whitney was still representing Grand Met, O'Hagan began purchasing call options for Pillsbury stock. Each option gave him the right to purchase one hundred shares of Pillsbury stock by a specified date, September 9, 1988. Later in August and September, O'Hagan made similar purchases making him the single largest individual Pillsbury investor. When Grand Met finally announced its tender offer in October, the price of Pillsbury stock rose nearly sixty dollars per share, earning O'Hagan a profit of more than \$4.3 million upon the sale of his stock.

The SEC initiated an investigation into O'Hagan's transactions, culminating in a fifty-seven-count indictment, alleging in relevant part that O'Hagan defrauded his law firm and its client, Grand Met, by misappropriating and using for his own trading purposes material, nonpublic information regarding Grand Met's tender offer. A jury convicted O'Hagan on all counts, and he was sentenced to a forty-one-month prison term.

Once again reflecting the split among judges in this field, it was a divided panel of the Court of Appeals for the Eighth Circuit that reversed all of O'Hagan's convictions. Liability under Rule 10b-5, the court held, "may not be grounded on the 'misappropriation theory' of securities fraud on which the prosecution relied."²⁷⁹

Following the rationale of *Central Bank* and *Bryan*, the Eighth Circuit ruled that liability under § 10(b) could not properly be based upon the misappropriation theory, because the theory "renders nugatory the requirement that the 'deception' [required under § 10(b)] be 'in connection with the purchase or sale of any security.'"²⁸⁰ The court held that "only a breach of a duty to parties to

276. *United States v. O'Hagan*, 92 F.3d 612 (1996), *cert. granted*, 117 S. Ct. 759 (1997).

277. Several months later, Dorsey & Whitney withdrew from representing Grand Met. Less than a month later, Grand Met publicly announced its tender offer for Pillsbury stock.

278. To cover the shortage, he defrauded other clients of the firm (for example, Mayo Brothers Medical Center was told by O'Hagan that he had settled a case for \$250,000, in which he represented Mayo's as a defendant in a malpractice action, whereas the settlement was for only \$25,000. O'Hagan kept the \$225,000 but still was in the red for covering the rest of his initial theft).

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

280. *Id.* at 618.

the securities transactions or, at the most, to other market participants such as investors," was sufficient to give rise to § 10(b) liability.²⁸¹

In short, the court reasoned that there was no "deception," and even if there were, such conduct did not occur "in connection with" a stock trade.²⁸² Once more, as it could have done with *Chiarella* seventeen years earlier or *Carpenter* a decade past, the Supreme Court had its third opportunity to resolve the issue. This time it did not disappoint.

VII. THE SUPREME COURT FINALLY RULES ON THE MISAPPROPRIATION THEORY

In early 1997, the Supreme Court agreed to review the *O'Hagan* decision. Popular sentiment expected the Eighth Circuit to be affirmed, with Justices Rehnquist, Scalia, and Thomas likely to be joined by Justice O'Connor, based on her dissent in *Basic Inc. v. Levinson*, and by Justice Kennedy having written his recent *Central Bank* opinion.²⁸³ On appeal to the High Court,²⁸⁴ the government argued that the misappropriation theory satisfied § 10(b)'s requirement of deception, because the act of converting the information to one's own benefit and by trading "on basis of," deceives the legitimate possessor.

O'Hagan countered by stating that the theory ignores a fundamental principle of regulatory power that "an administrative agency's interpretation of a statute under which it is given rule-making authority, is limited by the language of the statute itself."²⁸⁵ He also argued that the question of whether the

281. The Eighth Circuit also reversed O'Hagan's conviction under Rule 14e-3(a) designed to prohibit trading on the basis of material, nonpublic information concerning a pending tender offer. The rule creates an obligation to disclose the information or refrain from trading, regardless of whether the information was obtained through a breach of a fiduciary duty.

Once again, applying the methodology set out by the Supreme Court in *Central Bank*, and focusing on the text of 14e-3, the Eighth Circuit held that the SEC had overstepped its rulemaking authority when it promulgated Rule 14e-3(a) by failing to require that a breach of a fiduciary duty be shown, because the term fraud under Section 14(e) requires such a breach. *Id.* at 613.

282. This holding in *O'Hagan* conflicted with the decisions from the Second, Seventh, and Tenth Circuits, each of which had rejected the argument that the SEC exceeded its authority when it promulgated Rule 14e-3 without the requirement of a breach of a fiduciary duty. *Id.*

283. See, e.g., Marcy G. Dworkin, *The Misappropriation Theory as a Corollary to the Classic Insider Trading Theory*, 1996 ANN. SURV. AM. L. 315, 337 (1996); Hall, *supra* note 5; Phillips & Tutz, *supra* note 189; Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1172 (1987); Michael J. Chmiel, Note, *The Insider Trading and Securities Fraud Enforcement Act of 1988: Codifying a Private Right of Action*, 1990 U. ILL. L. REV. 645 (1990).

284. *O'Hagan*, 117 S. Ct. at 2199.

285. Brief for Respondent James Herman O'Hagan at 8, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 98-842).

misappropriation theory is necessary to combat securities fraud is a question for Congress and not the courts.²⁸⁶

Justice Ginsburg, writing for the majority,²⁸⁷ said that the misappropriation theory is a valid extension of § 10(b) of the Securities and Exchange Act of 1934 because it attacks the misuse of confidential information in breach of a fiduciary duty to its source. The majority rejected the argument of O'Hagan and the Eighth Circuit, observing that they "misunderstood" its requirements.²⁸⁸ The majority also concluded that the Eighth Circuit wrongly rejected the theory when it said that it lacked the elements of fiduciary duty, deception, and misuse of information in connection with the sale or purchase of securities.²⁸⁹

On the contrary, the new Supreme Court majority found that misappropriation does constitute deception, because it involves a breach of duty owed to the source of the information rather than to the persons with whom the defendant trades.²⁹⁰ In short, deceptive conduct occurs because the actor pretends loyalty to the principal, while secretly converting the principal's information for personal gain, thus duping or defrauding that principal. Deception through nondisclosure is central to the misappropriation theory, because if the defendant informs the source that he planned to trade on it, the scheme would be foiled from the outset. A person who learns inside information and secretly uses it to gain no risk profits has both deceived the source of the information and simultaneously harmed the investing public.²⁹¹ Further, the § 10(b) requirement of "in connection with the purchase or sale of a security" also is satisfied by the misappropriation theory, because the defendant's fraud is consummated not when he obtains the confidential information but when it is used for personal gain.²⁹²

In one of the most unusual "clarifications" of the law by the Court, the majority stated that if the person making the otherwise illegal trade first discloses to the one to whom he owes the "duty" that he is trading based upon the nonpublic information, he would not violate Rule 10b-5.²⁹³

Does this really mean that if Winans, in the *U.S. v. Carpenter*²⁹⁴ case, or even Vincent Chiarella, in his print shop, had told his employer what he was planning to do and the employer acquiesced, that the statute would be circumvented? Of course, other liability on the employee and employer may then exist, but is that type of reasoning consistent with Congress's criteria under this

286. *O'Hagan*, 117 S. Ct. at 2206-07.

287. Justice Ginsburg was joined in the majority with Justices Stevens, O'Connor, Kennedy, Souter and Breyer. Chief Justice Rehnquist and Justices Scalia and Thomas dissented from parts of the ruling. *Id.* at 2199.

288. *Id.* at 2210.

289. *Id.* at 2211.

290. *Id.*

291. *Id.* at 2209.

292. *Id.*

293. *Id.* at 2201.

294. *Carpenter v. United States*, 484 U.S. 19 (1987).

law? Doubtful certainly, but not surprising in view of the lack of definition and guidance from Capitol Hill in this field for over sixty years.

The SEC, of course, has long taken the position that the mere possession of misappropriated material, nondisclosed information violates the Securities Act.²⁹⁵ It is not quite clear if the court was rejecting that position by requiring an actual trade based upon that information. If the SEC reads the holding that way, it undoubtedly will seek to find another highly egregious set of facts, such as *O'Hagan*, to clarify this key point. Citing the *Carpenter* case, the majority declared:

A company's confidential information...qualifies as property to which the company has a right of exclusive use....²⁹⁶ [Further,] the undisclosed misappropriation of such information, in violation of a fiduciary duty...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."²⁹⁷

The court concluded its opinion by stating,

Vital to our decision that criminal liability may be sustained under the misappropriation theory, we emphasize, are two sturdy safeguards Congress has provided regarding scienter. 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.²⁹⁸

This rather startling statement could at first glance be read to mean that ignorance of the law is an excuse. However, the outrageous facts of *O'Hagan* precluded a thorough explanation of this position.

Moreover, wilfulness is still defined as knowing conduct.²⁹⁹ Does this eliminate recklessness as a theory of liability? That would be an enormous pro-defense result in the middle of the largest SEC victory in history in a Supreme Court decided insider trading case. More likely, this at least opens up a major area for further litigation—the same uncertain problem that has plagued the amorphous § 10(b) for decades. Regrettably, the political philosophy of the judges and their attitude toward judicial activism will determine the outcome once again and so the circle continues unchecked without clear congressional language.

Returning to the equal access theory presented in *Cady, Roberts*³⁰⁰ and *Texas Gulf Sulphur*,³⁰¹ the Court stated that

295. *In re Cady, Roberts Co.*, 40 S.E.C. 907 (1961).

296. *See O'Hagan*, 117 S. Ct. at 2208.

297. *Id.*

298. *Id.* at 2214 (footnote omitted).

299. *Id.*

300. *In re Cady, Roberts Co.*, 40 S.E.C. 907 (1961).

301. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

the misappropriation theory is tuned to an animating purpose of the Exchange Act: to ensure honest markets, thereby promoting investor confidence.

....

Although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.³⁰²

In response to O'Hagan's final argument that the misappropriation theory and § 14(e) were an overextension of the power Congress gave to the SEC to regulate the markets, the majority stated that the recent cases cited by O'Hagan and the Eighth Circuit to support their position were meant to limit the use of securities laws in private civil litigation, as opposed to criminal prosecutions.³⁰³ Thus, the elements of scienter and materiality are still essential in some contexts.

However, uncertainty still exists due to the majority's view that the defender must trade "on the basis" of the misappropriation information. For example, what if the trader contends that while he knew of the subject information, he was compelled to sell to raise cash for his spouse's critical cancer surgery? Is this now a question to be resolved at trial and, if so, by whom—the finder of fact (if a jury is used) or the judge?

Coincidentally, the Second Circuit has indicated that once someone possesses such knowledge it cannot be disaggregated from the defendant's thinking process.³⁰⁴ Thus, merely trading while knowing of the information, is sufficient for culpability even if the primary motivation is his spouse's medical treatment. The Supreme Court, however, has not yet resolved this issue.

VIII. THE FUTURE OF INSIDER TRADING REGULATION

A. Application of the O'Hagan Ruling to the Fact Patterns of Prior Cases

Justice Ginsburg did not try to define the outer limits of the government's power. She confined her opinion to persons who have some "duty of confidentiality" against using secret information.³⁰⁵ This prompted SEC Enforcement Chief William McLucas to state, "Although [the] decision confirms regulators' existing view of insider trading, it does not expand the playing field."³⁰⁶

On the contrary, one could argue that it clearly does so. Before this decision was handed down, the misappropriation theory was limited in scope to ad

302. *O'Hagan*, 117 S. Ct. at 2210.

303. *Id.* at 2216-17.

304. *SEC v. Mayhew*, 121 F.3d 44 (2d Cir. 1997).

305. *See O'Hagan*, 117 S. Ct. at 2219.

306. David G. Savage & Thomas S. Mulligan, *Court Ruling Backs SEC Even "Outsiders" Liable for Profiting from Tips*, L.A. TIMES, June 26, 1997, at D1 (citation omitted).

hoc, lower court cases. Previously, it was never fully recognized by the United States Supreme Court and, therefore, was not a complete option for prosecutors. This new viable option, by definition, is an expansion of the rule and encompasses a broader spectrum of potential violators. In addition, it gives prosecutors the ammunition to convict abusers of the system who were not convictable in the past due to the lack of recognition of this theory.

Specifically, if the previously discussed decisions were being considered today, many of their outcomes would likely have been different; but that alone does not overrule them. In those decisions, the misappropriation theory was barely touched upon and not directly addressed in any of the majority opinions. However, if similar cases arise in the future, the results should be very different from their predecessors.

To illustrate, in *Chiarella*,³⁰⁷ the printer who learned nonpublic material information while on his job and traded upon it was not guilty because of faulty jury instructions. These instructions were the focus of the decision, not the misappropriation theory, the latter being discussed only in a strong dissent.³⁰⁸

Looking at the facts today, we could expect the opposite result. *Chiarella* misappropriated information with which he was entrusted by his company. In *O'Hagan*, Justice Ginsburg applied her opinion to persons who have some "duty of confidentiality" against using secret information.³⁰⁹ Under this rationale, *Chiarella* may not have had a duty toward the specific companies whose information he used, but he did have a duty to his own company. These facts would parallel those in *Carpenter*, giving *Chiarella* a "fiduciary relationship" with his employer. Therefore, he would have misappropriated material nonpublic information that was obtained in the course of employment.

Similarly, in *Dirks*,³¹⁰ the defendant was investigating alleged fraudulent conduct by a corporation. During that effort, *Dirks* openly discussed the information he obtained with a number of clients and investors who acted upon this information. In 1987, *Dirks* was not convicted of violating Rule 10b-5 because there was no basis to reach him as a "tipper," because he did not benefit from the disclosure of the insider information. If this case were tried today, *Dirks* probably would be convicted of violating Rule 10b-5 via the misappropriation theory because it now reaches tippers who do not benefit from disclosure. The secret use of material "deceives the source of the information and nonpublic information simultaneously harms members of the investing public."³¹¹

B. Criticism of the Court's Rationale

The misappropriation theory has been criticized in large part for the confusion of its application. As stated by the Fourth Circuit Court of Appeals in

307. *Chiarella v. United States*, 445 U.S. 222 (1980).

308. *Id.*

309. *See O'Hagan*, 117 S. Ct. at 2219.

310. *Dirks v. SEC*, 463 U.S. 646 (1983).

311. *O'Hagan*, 117 S. Ct. at 2209.

United States v. Bryan,³¹² "[i]t would be difficult to overstate the uncertainty that has been introduced into the already uncertain law governing fraudulent securities transactions through adoption of the misappropriation theory, with its linchpin the breach of a fiduciary duty."³¹³ The court went further to say that "although fifteen years have passed since the theory's inception, no court adopting the misappropriation theory has offered a principled basis for distinguishing which types of fiduciary or similar relationships of trust and confidence can give rise to Rule 10b-5 liability and which cannot."³¹⁴

While it is true that other theories of insider trading liability, such as the traditional fraud based rationale, fail to prohibit all instances of unfair informational advantage in securities markets, the misappropriation theory also has many shortcomings. One of the most important criticisms is that it does not fit within the antifraud provision of Rule 10b-5.³¹⁵ It provides an improper extension of the proper scope of § 10(b), because it ultimately seeks to create an ill-defined "parity of information" rationale which has been previously rejected by the Supreme Court.³¹⁶

Under the misappropriation theory, Rule 10b-5 is violated whenever a person (1) "steals" material, nonpublic information (2) via a breach of duty arising from a trusting or confidential relationship and (3) thereafter, transacts upon the information regardless of whether he owed any duty to shareholders of the company in whose stock he trades.³¹⁷

However, the misappropriation theory does not meet the two-part test extracted from § 10(b)'s language. Section 10(b)'s wording specifically prohibits "manipulative" and "deceptive devices" employed "in connection with" the purchase or sale of any "security." The misappropriation theory loosely interprets § 10(b)'s "deception" and "in connection with" requirements by severing the link between the fraud (breach of duty) and the securities trade at issue. The theory brings within its scope parties who have no connection with issuers or their shareholders and is premised upon breaches of duty that have nothing to do with securities markets.

It can be argued that *O'Hagan* does not definitively resolve this question of to whom a duty is owed. If the test is whether the one from whom the information is misappropriated has an expectation that it will be kept confidential, when is it shared? Distinct possibilities could arise in which the communicator does not even have an opinion on that subject, (for example, idle gossip by a

312. 58 F.3d 933 (4th Cir. 1995).

313. *Id.* at 951.

314. *Id.*

315. See 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, 230-32 (1985); Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 200 (1991); Roberta S. Karmel, *Attacks on the Misappropriation Theory*, N.Y. L.J. (1996).

316. See Brodsky, *supra* note 170, at 109.

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

careless Senior VP of nondisclosed, material information while at her hairdressers—or to a bartender).

In such an example, the Senior VP probably would assume that her listener had no idea where she works and would not have money to invest anyway. Even if the bartender had available funds to buy the shares, the Senior VP likely would figure that he would not be sophisticated enough to interpret and act upon the information.

While the SEC might allege that the Senior VP is a tipper seeking to aid and abet her friendly bartender, that is not the factual pattern described. Nor has the Senior VP misappropriated the secret information if she learned it properly during the course of her officer-level duties. The misappropriation theory should not be applied to either person in this example because its definition, however strained already, does not encompass this hypothetical conduct.

It is only when an insider trades on material nonpublic information without disclosing it that she violates Rule 10b-5 because it is fraudulent to keep silent when there is a duty to disclose.³¹⁸ However, the employee's duty to the employer under the misappropriation theory has nothing to do with disclosure. Rather it is a duty to not use for personal gain the confidential information received in the course of employment.³¹⁹

The SEC's view of *O'Hagan's* interpretation of the misappropriation theory also would disallow the use of information in securities transactions obtained through familial and social relationships. Under its position, these relationships themselves create a duty to refrain from trading, although there is no relationship between the breach of duty and the securities transaction. Judicial extension of insider trading to a breach of duty not related to officers or directors has made Rule 10b-5 less predictable. As a result, market participants such as the bartender or hairdresser are given inadequate guidance regarding when it is proper to buy or sell securities, especially when they might not even know it is nonpublic information and it was acquired through a source unrelated to the eventual trade.

Moreover, to the extent that the pro-prosecutorial language of the majority can be read as encouraging the SEC to fashion new theories of criminal culpability without federal legislation, the court raises procedural and substantive due process questions as well as issues of fair notice of criminal sanctions.

In short, virtually every word within § 10(b) and Rule 10b-5 demands a definition which should meet the strictest scrutiny of the Supreme Court. Although the decision in *O'Hagan* accepted misappropriation within the parameters of § 10(b) and Rule 10b-5,³²⁰ it will remain unconvincing to many.

318. See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980).

319. Phillips & Zutz, *supra* note 189, at 91.

320. See *O'Hagan*, 117 S. Ct. at 2209–10.

IX. THE SEC'S VIEW OF ITS ROLE

A. Generally

Long taking an aggressive posture to expand the scope of liability and guilt, the SEC has characterized its authority as being to enforce the federal securities laws in a broad and flexible manner.³²¹ Unlike many other federal agencies, the SEC has been given broad authority to bring its own civil actions in federal district court and to institute administrative proceedings in which an administrative law judge may impose sanctions.³²² In matters brought in federal court, the SEC may obtain injunctive orders that prohibit future violations of the federal securities laws, seek temporary restraining orders *ex parte* and preliminary injunctions. Courts can order the payment of civil penalties in SEC actions³²³ and require defendants to return their illegal profits. Similarly, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990³²⁴ gives the SEC the power to institute administrative proceedings to obtain cease and desist orders against any person violating or causing violations of the federal securities laws and require the disgorgement of illegal gains.

Frequently, violations of the federal securities laws are prosecuted as criminal offenses³²⁵ because the SEC is authorized to refer matters to the Department of Justice for such action.³²⁶ The SEC also views its role as including the bringing of fraud actions against securities laws violators anywhere in the United States regardless of their state or county of residence. Courts have found subject matter jurisdiction where there is either "conduct or effects" in the United States relating to a foreign violation of the U.S. securities laws.³²⁷ Courts also have

321. See, e.g., § 21(d)(1) of the Exchange Act, 15 U.S.C. § 78u(d)(1) (1994).

322. *Id.*

323. The SEC first obtained significant authority to seek civil penalties in its insider trading cases, pursuant to the Insider Trading Sanctions Act of 1984 ("ITSA") and the ITSFEA, provisions that are codified in § 21A of the Exchange Act, 15 U.S.C. § 78u-1 (1994). The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Remedies Act") expanded this authority by providing penalties for any violations of the federal securities laws other than insider trading covered by ITSA and ITSFEA. The civil penalty provisions are codified in various sections of the statutes administered by the SEC, including § 21(d)(3) of the Exchange Act, 15 U.S.C. § 78u(d)(3) (1994). The statutory civil penalties, as adjusted for inflations, are set out in Table I to Rule 1001 of the Commission's Rules of Practice, 17 C.F.R. § 201.1001 (1998).

324. See, e.g., § 21C of the Exchange Act, 15 U.S.C. § 78u-3 (1994).

325. See, e.g., § 32 of the Exchange Act, 15 U.S.C. § 78ff (1994). Under the Exchange Act, individuals who willfully violate the statute may be fined up to \$1,000,000 and may be imprisoned for up to ten years. Corporations and entities other than individuals are subject to fines of up to \$2,500,000.

326. See, e.g., § 21(d)(1) of the Exchange Act, 15 U.S.C. § 78u(d)(1) (1994) ("The Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter.").

327. *Itoba Ltd. v. LEP Group PLC*, 54 F.3d 118 (2d Cir. 1995); *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974 (2d Cir. 1975); *Leasco Data Processing Equip. Corp. v.*

asserted personal jurisdiction over nonresident defendants in securities fraud cases.³²⁸ Moreover, to the SEC, the basic anti-fraud provision, §10(b),³²⁹ should reach virtually any fraud related to transactions in securities and not be limited to situations involving any particular technology related to the issuer whose shares are traded. With that strong orientation by the SEC, and no congressional guidance, the courts have been forced to integrate two fundamental fraud principles.

B. Specifically—The Continued, Troubling Concerns of Scienter and “In Connection With”

Two striking examples of the SEC's new aggression are demonstrated by its amicus participation in private suits under the Reform Act now pending federal appellate resolution.

*1. Scienter Under the Private Securities Litigation Reform Act*³³⁰

*In re Silicon Graphics, Inc. Securities Litigation*³³¹ is a class action under § 10b and Rule 10b-5 filed on behalf of purchasers of shares of Silicon Graphics, Inc, during which, it was alleged, the price of the shares was artificially inflated because of the defendant corporation's false and misleading statements about its current business and future prospects.

The District Court initially granted a defense motion to dismiss the original complaint, largely on the grounds that it did not meet the new higher requirements of what it believed the Reform Act required for pleading scienter. The court held that the plaintiff must allege specific facts that constitute circumstantial evidence of conscious behavior by defendants.³³² With respect to

Maxwell, 468 F.2d 1326 (2d Cir. 1972); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), *rev'd on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*).

328. See, e.g., SEC v. Carillo, 115 F.3d 1540 (11th Cir. 1997). See generally *International Shoe Co. v. Washington*, 326 U.S. 310 (1945) (*quoting* Milliken v. Meyer, 311 U.S. 437 (1940)).

329. Together with § 17a of the Securities Act of 1933.

330. The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 15 U.S.C. § 78u-4 (Supp. 1996).

331. 970 F. Supp. 746 (N.D. Cal. 1997), *appeal pending* (9th Cir.). The case has been split for purposes of appeal to the Ninth Circuit into *Janas v. McCracken*, Docket # 97-16204, and *Brody v. McCracken*, Docket # 97-16240. Oral argument in both cases was held on June 11, 1998, and the appeals are pending.

332. *Silicon Graphics*, 970 F. Supp. at 766. Specifically, it concluded that:

Based on the foregoing discussion, the Court finds that in order to state a private securities fraud claim, plaintiffs must create a strong inference of knowing or intentional misconduct. *Knowing or intentional misconduct includes deliberate recklessness....* Motive, opportunity, and non-deliberate recklessness may provide some evidence of intentional wrongdoing, but are not alone sufficient to support scienter unless the totality of the evidence creates a strong inference of fraud.

Id. at 757 (citations omitted) (emphasis added).

some of the allegations, the court gave leave to the plaintiffs to amend, which became the subject of a new motion to dismiss.

On the second round, the court interpreted the pleading standards to require, with particularity, the names of sources of such allegations and the specific facts told to the plaintiffs by such persons—a new and major burden.³³³ In addition to criticizing such heightened tests, plaintiffs' attorneys argued both the great expense to which they have to go to get past the inevitable motion to dismiss, but also the risk created by the mandated invitation to others to participate in the action even to take over the case as lead plaintiff without having done any of the initial work.³³⁴

The SEC filed an amicus brief in response to this new motion, to focus on the issue of whether the new pleading standard eliminated recklessness as satisfying the scienter requirement in private actions under § 10(b) of the Exchange Act and Rule 10b-5. The Ninth Circuit, when previously considering the question of the required degree of scienter, had held that recklessness was sufficient to establish liability under § 10(b) and Rule 10b-5.³³⁵ The new pleading standard should not, in the SEC's view, alter those holdings.³³⁶

The SEC argued that § 21D(b)(2) of the Reform Act, by its express terms, only purports to establish a standard for pleading. It does not in any way address, much less alter, the substantive elements of a violation. It emphasized that with respect to the meaning of scienter, in contrast to the method of pleading it, the language of the section is entirely neutral, referring only to the "required states of mind."³³⁷ In determining that § 21D(b)(2) required the pleading of conscious behavior, the SEC argued that the court previously had drawn from a purely procedural provision the incorrect conclusion that Congress had eliminated a well-established substantive standard.

However, the court thereafter issued a new order granting, in part, defendant's motion to dismiss the amended complaint. The court reaffirmed its earlier ruling that the Reform Act required plaintiffs to plead facts giving rise to a strong inference of knowing misrepresentation by the defendant.³³⁸ This holding, however, was tempered by the court's statement that a showing of "deliberate recklessness" would suffice.³³⁹ The opinion defined "deliberate recklessness" to mean conduct which presents such a danger of misleading buyers or sellers that the defendant either knew or must have been aware of it. Thus, the fact that this court's pleading test under the Reform Act is tougher than that of the Second Circuit implies that conscious acts by the defendant may be required.³⁴⁰ This strict definition of recklessness was first spelled out by the Seventh Circuit in

333. *Id.* at 767.

334. *Id.* at 757.

335. *Id.* at 754-57.

336. *Id.* at 753.

337. *Id.* at 758. Defined in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976), as "a mental state embracing an intent to deceive, manipulate, or defraud."

338. *Silicon Graphics*, 970 F. Supp. at 754-57.

339. *Id.* at 757.

340. *Id.* at 766-67.

*Sundstrand Corp. v. Sun Chemical Corp.*³⁴¹ Though the plaintiff in *Silicon Graphics* has now appealed to the Ninth Circuit, the holding already has been followed.³⁴²

Zeid v. Kimberley,³⁴³ which holds to the contrary, also is on appeal to that Circuit. These are the first cases submitted to a U.S. Court of Appeals which raise the question of the proper standard of pleading scienter under the Reform Act,³⁴⁴ an area of substantial uncertainty in an already confusing field.

2. The "In Connection With" Requirement Under the Reform Act

a. *Levitin v. PaineWebber, Inc.*,³⁴⁵ and *Bissell v. Merrill Lynch & Co., Inc.*³⁴⁶

In these two cases, plaintiffs were customers who alleged that broker-dealers failed to disclose that they were earning interest on collateral put up by customers to secure margin accounts. The district court dismissed the plaintiffs' complaints, holding that the alleged omission did not satisfy the "in connection with" requirement of § 10(b) because it did not pertain to a security or to the consideration for a security.

The SEC filed an amicus brief making two arguments: (1) that under Second Circuit precedent³⁴⁷ the "in connection with" requirement is satisfied when a broker-dealer makes a misrepresentation or omission with a reasonable expectation that it could influence a customer's securities trading, regardless of whether the deception pertains to a security,³⁴⁸ and (2) that in any event the requirement is satisfied when a broker-dealer makes a misrepresentation or omission that relates to a customer's brokerage account.³⁴⁹ While both cases were affirmed, a high court ruling is needed to finalize the matter.

341. 553 F.2d 1033 (7th Cir. 1977).

342. See *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297 (C.D. Cal. 1996).

343. 930 F. Supp. 431 (N.D. Cal. 1996).

344. *Id.*

345. 933 F. Supp. 325 (S.D.N.Y. 1996). It is interesting to note that the SEC has filed an amicus brief even in civil actions brought by private litigants if it fears a judicial ruling which could affect its pleading standards in the SEC's own cases. This case has been affirmed. No. 96-7994, 1998 WL 665039 (2d Cir. Sept. 29, 1998).

346. 937 F. Supp. 237 (S.D.N.Y. 1996), *aff'd*, 157 F.3d 138 (2d Cir. 1998).

347. *A.T. Brod & Co. v. Perlow*, 375 F.2d 393 (2d Cir. 1967).

348. Brief of the Securities and Exchange Commission, Amicus Curiae at 5-13, *Bissell v. Merrill Lynch & Co., Inc.*, 157 F.3d 138 (2d Cir. 1998) (No. 96-9137).

349. *Id.* at 13-14. See also *Levitin v. Pain Webber, Inc.*, 933 F. Supp. 325, 329-30 (S.D.N.Y. 1996).

b. *McGann v. Ernst & Young*

In *McGann v. Ernst & Young*³⁵⁰, the SEC once more filed an amicus curiae brief arguing that the district court erred in holding that the test for the "in connection with" requirement of § 10(b) of the Exchange Act set forth in *SEC v. Texas Gulf Sulphur Co.*,³⁵¹ had been implicitly overruled by the Supreme Court's 1994 decision in *Central Bank of Denver v. First Interstate Bank of Denver*.³⁵² It argued that the *Texas Gulf* test is correct. The district court held that only statements in offering documents (as distinguished from periodic reports, such as the Form 10-K involved in this case) meet the "in connection with" requirement. The SEC's brief argued that this construction of § 10(b), if accepted, would seriously impair its ability to bring enforcement actions to eradicate fraud and its attendant harm to the marketplace.³⁵³

The district court granted the defendant's motion for judgment on the pleadings, stating that the Supreme Court's decision in *Central Bank* requires that "the scope of prohibited conduct under § 10(b) must be determined by looking at the text of the statute and to the language of the express liability provisions of the 1934 Act."³⁵⁴ The court then concluded, without any further analysis, that "[w]hat Ernst did cannot be converted into making a false statement or committing a manipulative act 'in connection with' the sale or purchase of securities."³⁵⁵

Contrariwise, the SEC's amicus brief argued that the district court incorrectly rejected the long-standing principle that where a person makes a fraudulent statement with the reasonable expectation that it will be disseminated to the securities markets, he satisfies § 10(b)'s requirement that the fraud be "in connection with" the purchase or sale of securities as first enunciated in *SEC v. Texas Gulf Sulphur Co.*³⁵⁶ However, the district court viewed *Texas Gulf* as a "policy-based" decision, and held that it, and its successors, could be disregarded

350. 95 F.3d 821 (9th Cir. 1996), *amended and superceded by* 102 F.3d 390 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1460 (1997). The plaintiffs in this class action were purchasers of common stock of Community Psychiatric Centers ("CPC"), a New York Stock Exchange listed company. Defendant Ernst & Young, LLP ("Ernst") was CPC's outside auditor. The complaint alleged that Ernst knowingly or recklessly issued a materially false and misleading opinion letter that it knew would appear in CPC's financial statements contained in a Form 10-K filed with the SEC. According to the complaint, the plaintiffs would not have purchased CPC stock at the prices they paid, or bought at all, if they had been aware that the market prices had been falsely inflated by Ernst's misleading statements. Such an allegation as "or bought at all" raises the enormous problem of hypothetical transactions that would or would not have taken place but for the defendants' fraud.

351. 401 F.2d 833, 860 (2d Cir. 1968).

352. 511 U.S. 164 (1994).

353. *McGann v. Ernst & Young*, No. SA CV93-814AHS, 1995 WL 852119 at *7 (C.D. Cal. May 30, 1995).

354. *Id.*

355. *Id.*

356. 401 F.2d 833 (2d Cir. 1968).

because they are inconsistent with *Central Bank's* rejection of policy-based statutory construction.³⁵⁷

The Court of Appeals thereafter reversed the district court, agreeing with all of the arguments advanced by the SEC and rejecting the district court's conclusion that *Texas Gulf* and its progeny were in effect overruled by *Central Bank*. The court stated that "reports of *Texas Gulf's* demise are greatly exaggerated,"³⁵⁸ and that there is "no tension between the holding of *Central Bank* and the holding of *Texas Gulf*."³⁵⁹ Rather, the court explained in detail that the *Texas Gulf* test is fully consistent with the text and structure of § 10(b).³⁶⁰

The court also found that, even after *Central Bank*, it is proper for a court to look to policy considerations in construing § 10(b).³⁶¹ Noting that Congress had "broad remedial goals,"³⁶² when it enacted the securities laws, it found that these goals are best served by interpreting § 10(b) to impose liability on "all whose false assertions are reasonably calculated to influence the investing public."³⁶³ Thus, the stage is set for more uncertain controversy, inconsistency and costly litigation, despite Congress' intention to "reform" securities litigation.

C. Is There Any Role for RICO?

Any discussion of plaintiffs' remedies for securities fraud needs to address one of the most aggressively and, perhaps, overused newer federal statutes—the RICO law.³⁶⁴ While the initial, primary focus of RICO was directed toward organized crime, it also creates a private cause of action for "any person injured in his...property by reason of...a pattern of racketeering activity."³⁶⁵

Could RICO possibly provide a route by which a plaintiff could avoid Rule 10b-5 problems of materiality, causation, standing, scienter, and reliance? One commentator has suggested that the provisions of RICO should be liberally construed to achieve its objective, including securities fraud.³⁶⁶ At the time of that article, almost one third of the civil RICO cases on file were predicated on securities fraud violations.³⁶⁷ One reason may well have been that unlike §§ 10(b) and 20(A), the civil RICO Act allows for punitive and treble damages as well as the recovery of attorneys fees, rarely allowed in traditional securities cases.

357. *McGann*, 1995 WL 852119 at *7.

358. *Id.* at 825.

359. *Id.*

360. *Id.* at 825–28.

361. *Id.* at 827.

362. *Id.*

363. *Id.* at 828.

364. 18 U.S.C.A. §§ 1961–68 (1994 & Supp. 1996).

365. *Id.* A typical example of racketeering includes "any act which is committed for financial gain...involving...theft...or intentional or reckless fraud in the purchase or sale of securities." See e.g., ARIZ. REV. STAT. § 13-2301(D)(4) (1997).

366. Arthur F. Mathews, *Shifting the Burden of Losses in the Securities Markets: The Role of Civil RICO in Securities Litigation*, 65 NOTRE DAME L. REV. 896 (1990).

367. *Id.* at 930.

Although federal courts have exclusive jurisdiction over all securities claims under the Securities Exchange Act, including § 20(A), states have concurrent jurisdiction with federal courts regarding the civil RICO statute. This overlapping jurisdiction is consistent with the remedial purposes of the Securities Exchange Act. Since the Supreme Court decision in *Tafflin v. Levitt*,³⁶⁸ a plaintiff can now bring a civil RICO case in state court based on a § 10(b) securities fraud predicate violation, which also could contain a § 20(A) claim. Moreover, the Ninth Circuit has held that there is no purchase or sale requirement in a civil RICO securities fraud case.³⁶⁹

However, all of this preceded the *O'Hagan* case and its revival of the misappropriation theory. Thus, it seems unlikely that RICO will be needed by aggrieved plaintiffs, but should the *O'Hagan* ruling be narrowed in the future, it remains available as an intriguing and distinct possibility.

X. FUTURE SCENARIOS

A. Possible Defendants

Now that the misappropriation theory has been recognized, is there a limit to how far it can go? This question will most likely arise in a new debate over the identity of the parties. In looking at the total playing field, certain participants in the insider trading practice are easily identifiable as violating Rule 10b-5 and should be considered insiders. A clear illustration is the CFO of a corporation who trades or tips others based on information acquired as a result of her position. This situation, in most cases, would not even require the application of the misappropriation theory, but if necessary it could be so used.

Contrariwise, certain participants are not easily identifiable as insiders via the misappropriation theory. What if the CFO of a corporation has a secretary who overhears a conversation outside the office about the possible takeover of her corporation by another company? Let us assume that this information is overheard at a conference of secretaries. Is this secretary violating Rule 10b-5 if she trades on the information? Will the misappropriation theory reach her?

There is a chance that it will, because she is converting information about a corporation to which she now apparently has a fiduciary duty of nondisclosure. Arguably, the secretary would be misappropriating nonpublic, material information to her own use. If the secretary tells her nonincorporated stock club about the probable takeover, are its members in violation of Rule 10b-5 if the club itself trades or if they do so individually? Does the misappropriation theory have them within its grasp or are they outside the scope of the law? If one accepts "equal access to the market" and "inherent unfairness" to other traders as viable rationales, they might be within the reach of the misappropriation theory. If one focuses on fiduciary relationships, a contractual delegation, or a similar "duty" to the owner or rightful possessor of the information, the club members will most likely be considered outside the scope of the theory, because they have no

368. 493 U.S. 455 (1989).

369. *Securities Inv. Protection Corp. v. Vigman*, 908 F.2d 1461 (9th Cir. 1990).

connection with the corporation whose stock is being traded. Similarly, the identity of defendants and standards of proof under § 20(a) and the Reform Act raise serious issues.

First a word about § 20(a) of the 1934 Act.³⁷⁰ The purpose of this controlling person provision is, according to the general view of the courts, "to impose secondary liability on one who controls the violator of the securities laws."³⁷¹ From that point, however, there is a confusion among the district and circuit courts as to the required element of proof. The primary view is that a prima facie case is established by demonstrating (a) a primary violation by the controlled person, and (b) control of the primary violator by the targeted defendant.³⁷² After that point, however, there is considerable debate among lower courts whether the Reform Act³⁷³ requires one to plead facts necessary to demonstrate a significant inference of conscious misbehavior or only recklessness on the part of the defendant.³⁷⁴

In *SEC v. First Jersey Securities*, the plaintiff's prima facie case was required to include facts showing that "the controlling person was in some meaningful sense a culpable participant in the fraud perpetrated by the controlled person."³⁷⁵ Another court has said that the facts the plaintiff needs to assert are "some indirect means of discipline or influence short of actual direction to call [the defendant] liable."³⁷⁶

In *Hollinger v. Titan Capital Corp.*,³⁷⁷ the plaintiff was not required to show "culpable participation" in order to establish that a broker dealer was vicariously liable as the controlling person for the registered representative's conduct. Instead, liability was based on the controlled relationship, subject to a good faith defense by the defendant.³⁷⁸

Contrariwise, in *Brug v. Enstar Group*,³⁷⁹ the court held that to establish a controlled person liability under the Securities Exchange Act, "the plaintiff must not only show that the particular person was a control person, but also that he or she either participated in the fraud or intentionally furthered fraud through inaction."³⁸⁰ There, the plaintiffs claimed that the president and chairman were

370. 15 U.S.C. § 78t(a) (1994).

371. *Borden, Inc. v. Spoor Behrins Campbell & Young*, 735 F. Supp. 587, 588 (S.D.N.Y. 1990).

372. *SEC v. First Jersey Sec.*, 101 F.3d 1450 (2d Cir. 1996), *cert. denied*, 118 S. Ct. 57 (1997).

373. Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 15 U.S.C. (Supp. 1996)).

374. See *In re Silicon Graphics, Inc. Sec. Litig.* 970 F. Supp. 746 (N.D. Cal. 1997); *Friedberg v. Discreet Logic, Inc.*, 959 F. Supp. 42 (D.C. Mass. 1997).

375. See *First Jersey Securities*, 101 F.3d at 1472, (quoting *Lanza v. Drexel Co.* 479 F.2d 1277, 1299 (2d Cir. 1973) (en banc)).

376. *Harrison v. Dean Witter Reynolds*, 974 F.2d 873, 880 (7th Cir. 1992) (quoting *Myzel v. Fields*, 386 F.2d 718, 738 (8th Cir. 1967)).

377. 914 F.2d 1564 (9th Cir. 1990).

378. *Id.* at 1574.

379. 755 F. Supp. 1247, 1256 (D. Del. 1991).

380. *Id.* at 1257 (quoting *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 889, 890 (3d

controlling persons, but they did not allege facts sufficient to plead successful liability because they did not demonstrate "culpable participation or deliberate inaction of those [two key persons]."³⁸¹ Yet, in *Borden v. Spoor Behrins Campbell & Young*,³⁸² another court noted that in order to state a claim, neither scienter nor culpable participation need be pleaded; all that need be plead is control status.³⁸³

Under the Reform Act, it would appear that either the Second Circuit's *Time Warner*³⁸⁴ rule or more will be required to plead, and that "culpable participation" or "scienter" will need to be demonstrated, not just merely proof of a controlled relationship, which would transfer the burden over to the defense to show good faith. Finally, in *Paracor Finance v. General Electric*,³⁸⁵ the Ninth Circuit said that the plaintiff need not show scienter or culpable participation.³⁸⁶

Once again because of Congress's ambiguity, it has been left to the courts to interpret these rules. However, a Supreme Court opinion interpreting the 1995 Reform Act as it applies to this section is also needed.

B. Predicting the Supreme Court

Over the years, the philosophy that there is some fundamental "unfairness" in trading activity exists in the securities markets has prompted the SEC to give an expansive interpretation of § 10(b) and Rule 10b-5. Yet, the scope given to § 10(b) to prohibit insider trading remains unclear, and its evolving interpretation within the federal courts has led to inconsistent case results. Such inconsistencies continue to occur because Congress has never enacted a statute that specifically defines a violation of insider trading. Furthermore, the Supreme Court's decisions have vacillated from one rationale to another depending upon the makeup of the court.

The Court's piecemeal approach to insider trading regulation under § 10(b) and Rule 10b-5 has now created a violation which is dependent upon case-by-case analysis. As a result, persons participating in securities markets and their counsel confront a significant degree of uncertainty when they try to ascertain the difference between permitted and prohibited activity.

This was especially the situation in the *O'Hagan* case, in which the attorney-defendant undoubtedly knew of the Supreme Court's holdings throughout the 1970s and 1980s. O'Hagan surely believed that he was complying with the *Dirks* and *Chiarella* rationale when he traded on the information he attained regarding Grand Met's desire to take over Pillsbury. Commentators predicted that the Supreme Court would follow a strict textually based, statutory construction,

Cir. 1975)).

381. *Id.*

382. 735 F. Supp. 587 (S.D.N.Y. 1990).

383. *Id.*

384. *In re Time Warner, Inc.*, 9 F.3d 259 (2d Cir. 1993).

385. 96 F.3d 1151 (9th Cir. 1996).

386. *Id.* at 1161.

invalidating the "misappropriation theory" as an invalid extension of § 10(b) and Rule 10b-5.³⁸⁷

Since it did not do so, the question becomes, will the court continue to judicially legislate so that a second, third, or even fourth degree tippee (the permutations are virtually endless), or the classic eavesdropper be included? For example, if a Barry Switzer type case³⁸⁸ was presented to the court once again, would he be found guilty?

The SEC thinks so, and is taking aggressive action to expand the law by using § 21(A)³⁸⁹ which imposes an antitrust-type penalty of "three times the profit gained or loss avoided" from insider trading and even a "bounty" to informants.³⁹⁰

Moreover, it is interesting to note that the so-called "swing votes" of Justices Kennedy and O'Connor (both President Reagan appointees), who had previously written opinions strongly criticizing an expansion of § 10(b),³⁹¹ sided with the majority. Had they agreed with the strongly worded dissent of Justices Rehnquist, Scalia, and Thomas, and voted as many anticipated, the decision would have come out five to four the other way.

The unexpected Supreme Court ruling in *O'Hagan* further supports the argument that there is insufficient certainty and predictability in the enforcement of insider trading laws. The impact of this decision will be significant upon those trading based upon material information.

With the SEC's aggressive attitude, and six members of the court now accepting the misappropriation theory, it appears that, effectively, *Santa Fe Industries, Inc. v. Green*,³⁹² requiring more than mere unfairness in a securities transaction, has been put on the shelf. A breach of fiduciary duty is now actionable

387. See Hall, *supra* note 5. See, e.g., Kenny & Thebaut, *supra* note 196; Bainbridge, *supra* note 196, at 1193.

388. SEC v. Switzer, 590 F. Supp. 756 (W.D. Okla 1984).

389. 15 U.S.C. § 78u-1 (1994).

390. *Id.* § 78u-1(e).

(e) Authority to award bounties to informants

Notwithstanding the provisions of subsection (d)(1) of this section, there shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney General, such sums, not to exceed 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payments, shall be in the sole discretion of the Commission, except that no such payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organization. Any such determination shall be final and not subject to judicial review.

391. See Justice Kennedy in *Central Bank*, 505 U.S. 959 (1993), and Justice O'Connor in her strongly worded dissent with Justice White in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

392. 430 U.S. 462 (1977).

under 10b-5, unless there was an absolute, full disclosure of all relevant facts before trading.

On that point, the question posed in *Basic Inc. v. Levinson*³⁹³ by the then dissenting opinions of Justices White and O'Connor becomes relevant once again: the concerns involving the extreme problems of releasing information based on the mere possibility of corporate results (for example, negotiations regarding a merger). How do companies read *O'Hagan* in terms of deciding when to release information which may even be embryonic in nature? Litigation may result no matter whether it errs on the side of disclosure of even preliminary negotiations, waits until the agreement is signed, or chooses a middle ground.

With regard to tippees, *O'Hagan* seems to have upheld the requirement in the *Dirks* case that the government needs to prove a breach of duty on the part of the tipper before holding a tippee liable. However, any questions regarding the press releases of material information and their accuracy or omissions must once again be reviewed by in-house counsel and outside lawyers advising corporations. In-house counsel will need to establish procedures to verify that corporate officers and others with access to material information will be limited in number and use that data with extraordinary care.

Moreover, securities class actions and private individual suits filed since the enactment of the Reform Act show an increased number of plaintiffs seeking to tie "contemporaneous" securities class actions to allegations of improper trades by corporate insiders. In-house counsel has an extreme duty to tighten procedures in this area.

Likewise, after the *O'Hagan* decision, the government undoubtedly will strongly pursue the nondisclosure of information involved in a tender offer under §14e-3,³⁹⁴ upheld by the Court, particularly when there is a great deal of trading activity before a press release. While there is a corporate duty to safeguard critical information, the government's burden of proof will be significantly less after *O'Hagan*. Similarly, stockbrokers and their officials will have an even more extreme duty to preserve confidential information under Rule 10b-5 as well as 14e-3.

Controversially, the SEC has taken the position that merely possessing nonpublic information is enough to violate the law. What happens, however, when a securities firm continues to trade in a security for its customers while that firm's investment banking division is completing a major transaction that has not yet been disclosed? Can one part of the brokerage house make the other culpable?

Hopefully, the *O'Hagan* case seems to say that mere possession is not enough, and that the test for insider trading liability still is whether or not the defendant engaged in his transaction on the basis of material nonpublic information. The court stated,

the fiduciary fraud is consummated...when, without disclosure to his principal, he uses the information to purchase or sell securities.

393. 485 U.S. 224, 258-59, 261-62 (1988).

394. S.E.C. Rel. No. 34-17120, 45 FED. REG. 60410 (1980).

The self-serving use of a principal's information to purchase or sell securities is a breach of a duty of loyalty and confidentiality which defrauds the principal of the exclusive use of that information.³⁹⁵

Doctrinally, this also would be the time to reexamine the plurality opinion of *Basic Inc. v. Levinson*³⁹⁶ regarding the efficacy of the "fraud on the market" theory.³⁹⁷ Can there really be an "efficient market" giving "equal access" to all? Regrettably, the combination of these three events (§ 20(A), the Reform Act, and *O'Hagan*) means that the SEC and the judiciary will continue to be able to create more insider trading law on an ad hoc basis: not the most appropriate manner to effectuate equal justice.

Furthermore, as the makeup of the Supreme Court changes with time, it is likely that its decisions regarding insider trading regulation will alter as well. This leads to a compelling argument that legislation is necessary to finally put to rest the problems associated with enforcement of these insider trading laws.

XI. CALL FOR ACTION: TWO ALTERNATIVE APPROACHES

A. Congressional Leadership

For over two decades, the United States Supreme Court has been asking Congress to implement a set of standards for regulating so-called insider trading of securities. As Justice Rehnquist remarked in *Blue Chip Stamps v. Manor Drug Stores* in 1975:³⁹⁸ "it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942, foreordained the present state of the law with respect to § 10(b)(5)."³⁹⁹ What has happened since has exacerbated the problem.

As a starting point, Congress need look no further than the § 10(b)'s sister provisions, adopted at the same time in the 1934 Act: §§ 16(a) and (b).⁴⁰⁰ These sections provide a clear, straightforward legal scheme to deter insider trading, in complete contrast to § 10(b), which has none of the following provisions.

First, § 16(a) identifies the defendant: an officer, director, or ten percent shareholder of any equity security registered pursuant to § 12 of the Securities Exchange Act.⁴⁰¹ Moreover, it applies "irrespective of any intention on the part of [the trader]."⁴⁰² Its definition of damages is likewise clear, applying to "any profit realized by him from any purchase and sale or sale and purchase...." There is even a statute of limitations of two years, unlike § 10b, which had none in its original language.⁴⁰³

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

396. 485 U.S. 224 (1988).

397. *Id.* at 227.

398. 421 U.S. 723 (1975).

399. *Id.* at 737.

400. 15 U.S.C. § 78p (1994).

401. *Id.*

402. *Id.*

403. *Id.* A major void in § 10(b) was any mention of a statute of limitations. The

With §§ 16(a) and (b) cases, there has been no need for such difficult and inconsistent judicially legislated concepts in § 10(b) and Rule 10b-5 decisions, of scienter, duty, privity, fraud on the marketplace, reliance, causation, materiality, misappropriation, tippees, and even eavesdroppers.

Perhaps §§ 16 (a) and (b) are what Congress had in mind all along for the governance of this area of the law. As Second Circuit Judge Winter stated in *United States v. Chestman*,⁴⁰⁴

The existence of § 16(b) which indicates that Congress expressly addressed the issue, might well have led the SEC and the courts to conclude that Congress intended that § 16(b) be the sole provision governing insider trading. No other provision explicitly addresses the problem, and § 16(b) eliminates what is perhaps the most obvious danger inherent in insider trading, namely the creation of an incentive for directors or officers to make share price volatile in order to profit from short swing trading. Moreover, one might have inferred from § 16(b)'s mechanical approach, ignoring purpose and actual profit, that regulation of insider trading without legislative or regulatory guidelines would involve a mare's test of analytic and definitional problems.⁴⁰⁵

Today, Congress could decide to interpret § 10(b) in areas where the Supreme Court's decisions have been inconsistent. After *O'Hagan*, this could actually encourage Congress to legislate the misappropriation theory. Alternatively, it could create a sweeping reform which would likely find its basis in the *Chiarella/Dirks* framework.

Optimistically, its historic failure to overhaul the securities laws and enact a definition of insider trading to date does not necessarily indicate that Congress is unwilling to accept either approach. At its disposal are nearly seventy years of judicial scrutiny of both § 10(b), and Rule 10b-5. However, it seems unrealistic to expect Congress to act at this point despite calls for such action by Supreme Court Justices and commentators. As a result, the following alternative is suggested.

federal courts had generally used applicable state law, hardly a predictable approach and one that led to frequently inconsistent results. In 1991, in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), a majority of the Supreme Court held that § 18 of the 1934 Act, applied, essentially a one-year period from discovery of the facts and 3 years after the cause of action accrued. In *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529 (1991), decided concurrently, the Court said that this new interpretation of a statute of limitations applied retroactively to all parties. Convictions of such infamous defendants as Ivan Boesky and Michael Milken were set aside.

Congress retaliated again by adopting § 27a, 15 U.S.C. § 78aa-1(b) (1994), allowing cases which were timely filed in their jurisdiction before the *Beam* case to be reinstated. However, the Court had the last word later, declaring the new § 27a law unconstitutional in *Plaut v. Spendthrift Farm Inc.*, 514 U.S. 211 (1995).

404. 947 F.2d 551, 572 (2d Cir. 1991).

405. *Id.* at 572-73.

*B. Judicial Restraint on the Identity of the Plaintiff—Problems with Expanding the Players**1. The Judiciary versus Congress*

The *Kardon*⁴⁰⁶ case in 1947 established an implied private cause of action, modified by the Second Circuit's *Birnbaum*⁴⁰⁷ decision in 1952, requiring that the plaintiff must be a purchaser or seller of securities (or the SEC). Those decisions were essentially confirmed in *Blue Chip Stamp v. Manner Drug Stores*⁴⁰⁸ in 1975. Since then, virtually all of the focus has been on the identity of the defendant in such cases. *O'Hagan*⁴⁰⁹ was just the next incremental step in the line.

The major focus now should be on the identity of the plaintiffs. In 1988, § 20(A)⁴¹⁰ was adopted, establishing claims by contemporaneous traders against defendants engaged in insider trading. A five-year statute of limitations applies, following the last violating trade. Claims also may be brought against those allegedly in "control" of the violator, presumably entities such as Mr. O'Hagan's law firm.⁴¹¹

Serious questions immediately arise about the current definition of "contemporaneous," particularly if the defendant's conduct extends over several days or weeks, a typical scenario. Could the plaintiff argue that (a) he would have bought or sold, or (b) would have not bought or sold, or (c) would have bought or sold more or less shares, or (d) would not have bought or sold more or less shares (depending upon the direction of the stock price) had he only known the same information used by the defendant? What stock price should be used? How would this Joe Six-Pack prove that precise moment in time when he would have traded?

The actual price of the stock also would be inaccurate because the defendant's illegal trade volume influenced that price. Should economists be called by all parties to determine what the "real" price should have been?

Speculative as these damages and price calculations appear to be, Congress once again has provided no guidelines. Its confusing numbering system is bad enough; however, § 20(A) of ITSFEA does not even have a definition of profits and losses.⁴¹² Section 21(A) includes one,⁴¹³ but are the courts once again to apply provisions of different sections to others? This uncertainty also will continue without further clarification from Congress. A closer look at ITSFEA is instructive for predicting the identity of plaintiffs in the future.

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- 406. *Kardon v. National Gypsum*, 73 F. Supp. 798 (E.D. Pa. 1947).
 - 407. *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952).
 - 408. 421 U.S. 723 (1975).
 - 409. *United States v. O'Hagan*, 117 S. Ct. 2199 (1997).
 - 410. 15 U.S.C. § 78t-1(a) (1994).
 - 411. *Id.*
 - 412. *Id.*
 - 413. 15 U.S.C. 78u-1(f) (1994).

2. Eligible Plaintiffs: Early Rulings Before § 20(A)

In *Laventhall v. General Dynamics Corp.*,⁴¹⁴ the Eighth Circuit held that a plaintiff who sold call options did not have standing to sue a defendant who had bought stock under Rule 10b-5. The court relied primarily on language in *Chiarella*,⁴¹⁵ holding that Rule 10b-5 required a "special relationship" between a buyer and a seller.

Other courts did not permit such suits either, referring to the complexity and uncertainty of proof, particularly in the computation of damages. Among the cases in which private actions were not permitted against defendants trading on the basis of inside information is *Fridrich v. Bradford*,⁴¹⁶ where the defendants did not purchase shares from the plaintiffs and their trading in no way affected the plaintiffs' decision to sell. However, the court suggested that private civil liability does not need to be coextensive within the reach of the 1934 Act.⁴¹⁷

In *Moss v. Morgan Stanley Inc.*,⁴¹⁸ and *Moss v. Newman*,⁴¹⁹ the defendants were alleged tippees of the so-called "aggressor" in a proposed tender offer who traded shares in the target company. The courts held that these tippees owed no duty to the plaintiffs because they traded in an impersonal market.

Contrariwise, in *State Teachers Retirement Board v. Fluor Corp.*,⁴²⁰ the defendants were found to have, in fact, purchased shares sold by the plaintiff on the basis of insider information, resulting in a reversal of a lower court's dismissal of the complaint.

Cases antedating § 20(A) that permitted private actions required that the plaintiffs have "traded contemporaneously" with the defendants. In *Wilson v. Comtech Telecommunications Corp.*,⁴²¹ the Second Circuit held that a duty of disclosure on the part of insiders trading in the open market "is owed only to those investors trading contemporaneously with the insider; noncontemporaneous traders do not require the protection of the 'disclose or abstain' rule because they do not suffer the disadvantage of trading with someone who has superior access to information."⁴²² The court held that the plaintiff's trades, which took place about one month after the defendant's, were not "contemporaneous."⁴²³

In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,⁴²⁴ the court held that trading within a four-day period was "contemporaneous," and in *Neubronner v. Milken*, a 1993 pre-§ 20(A) transaction,⁴²⁵ the court dismissed a

414. 704 F.2d 470 (8th Cir. 1983).

415. *Chiarella v. U.S.*, 445 U.S. 222, 229 (1980).

416. 542 F.2d 307 (6th Cir. 1976).

417. *Id.*

418. 719 F.2d 5 (2d Cir. 1983).

419. 465 U.S. 1025 (1984).

420. 654 F.2d 843 (2d Cir. 1981).

421. 648 F.2d 88, 94-95 (2d Cir. 1981).

422. *Id.* at 94.

423. *Id.*

424. 495 F.2d 228 (2d Cir. 1974).

425. 6 F.3d 666, 670 (9th Cir. 1993).

complaint that alleged contemporaneous trading over a three-year period when the plaintiff could not particularize the timing of his trade.

Several lower courts also have divided on the somewhat bizarre situation in which an *in pari delicto* defense is applicable in such cases. The United States Supreme Court finally resolved that disagreement in *Bateman Eichler, Hill Richards, Inc. v. Berner*,⁴²⁶ in which the Court stated that a plaintiff should be barred in these circumstances only where "(1) as a direct result of his own actions, the plaintiff bears at least substantially equal responsibility for the violations he seeks to redress, and (2) preclusion of suit would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public."⁴²⁷

The broader the period that is deemed to be "contemporaneous" the greater the exposure of the defendant, although it is difficult to explain why a person who traded on an impersonal stock exchange four days after the defendant's trade should have a cause of action while one who traded one month later does not. In neither case is the transaction based on anything more than chance.⁴²⁸ Moreover, this Joe Six-Pack "victim" could argue that had he only known of the defendant's conduct, he would have sold or bought, or declined to do so (based on the direction of the stock price); both hypothetical transactions. Disturbingly, Congress seems to have left this door open as well.

3. Post § 20(A) Cases

Since adoption of § 20(A),⁴²⁹ courts have taken a unique approach concerning individual shareholders claiming to be "contemporaneous trader" plaintiffs.

In *Fujisawa Pharmaceutical Co. v. Kopoor*,⁴³⁰ a district court held that no claim could be asserted under § 20(A) by someone who had a direct face-to-face transaction. Such a person needed to proceed under the operable state blue sky law. By the phrase, "contemporaneous traders," said the court, "Congress meant those individuals who, like the plaintiffs in *Shapiro*, purchased stock anonymously on the open market."⁴³¹

While on its face this view seemed to limit such claims, what it did was to eliminate only those rare situations in which one has an individual privity relationship with the defendant. It left open claims by any "anonymous" seller, buyer, or would-be trader, including speculative traders.

426. 472 U.S. 299 (1985).

427. *Id.* at 310-11.

428. William K.S. Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5?*, 54 S. CAL. L. REV. 1217, 1274-84 (1981).

429. 15 U.S.C. § 78t-1 (1994).

430. 932 F. Supp. 208 (N.D. Ill. 1996).

431. *Id.* at 210.

Fortunately, a few cases have limited this liability. In *Chanoff v. U.S. Surgical Corp.*,⁴³² a stockholder who had bought his shares more than a month before the most recent illegal trade by the corporate officer, was not considered a "contemporaneous" investor for purposes of stating a federal claim based on insider trading.⁴³³ In the case of *In re Verifone Securities Litigation*,⁴³⁴ the stock purchases by the plaintiffs occurred at least two weeks apart from the transactions of the insider defendants. These investors were held to have failed to meet the requirement that the trades occurred "contemporaneously."⁴³⁵

In a similar decision, *Alfus v. Pyramid Technology Corp.*,⁴³⁶ the court said that a class action could not be formed by all those who may have traded between the time of the defendants' illegal stock sale and the corporation's remedial disclosure of the material information, which took a period of four and a half months. Individual proof by the specific plaintiff was needed to give standing that one was a contemporaneous trader with the defendants.

Most recently, in *Clay v. Riverwood International Corp.*,⁴³⁷ a plaintiff who bought common stock on the same day that executives of the issuer exercised stock options previously granted them, lacked standing to sue those executives for insider trading. The court found that there was no transactional nexus between the executives' exercise of their privilege and the plaintiff's purchase of stock. In short, the Securities Exchange Act prohibiting purchase or sale of securities by an insider who has material information not known to the public only applies to "contemporaneous" insider transactions.⁴³⁸

Where the line can be drawn, however, becomes the classic argument of the beard, and guidance is needed from Congress. Moreover, how the Reform Act's pleading standards finally will be applied also remains an open question at this time because of the uncertainty of Congressional language and the absence of U.S. Supreme Court opinions.

4. Limits Are Necessary Now

It is suggested that lines should be drawn at this point, and that implied private causes of action under § 20(A) should not be extended against individual defendants under the misappropriation theory.

Examine for a moment the possibilities of the identity of the plaintiff in such cases. The vast majority of all common stockholders own their shares either through mutual funds or institutions.⁴³⁹ If one were to inquire of the average investor (the so-called Joe Six-Pack) for the names of even a few of the companies

432. 857 F. Supp. 1011 (D. Conn. 1994).

433. *Id.* at 1021-23.

434. 784 F. Supp. 1471 (N.D. Cal. 1992), *aff'd*, 11 F.3d 865 (9th Cir. 1993).

435. *Id.* at 1489.

436. 745 F. Supp. 1511 (N.D. Cal. 1990).

437. 964 F. Supp. 1559 (N.D. Ga. 1997).

438. *Id.* at 1568.

439. MUTUAL FUND OWNERSHIP IN THE U.S.: FUNDAMENTALS: INVESTMENT COMPANY INSTITUTE RESEARCH IN BRIEF (1996).

which his mutual fund owns, he undoubtedly could not do so. He probably would not even be interested. His concern is to make money for his account, and rightly so. The best that he probably could do would be to identify the name of the investing corporation, for example, Fidelity, Franklin, Vanguard, or Merrill Lynch.⁴⁴⁰ It would be likely that many such investors would not even know the specific fund name.

Indeed, if he were actually given the list of stocks which composed the portfolio of his fund, it is probable that he would not even recognize the names of most of the companies or the types of businesses in which they are engaged. Is this wrong? Of course not. It is his right as an investor. He is only focusing on bottom-line results—in effect, a form of legalized gambling not much different from the Las Vegas blackjack tables. However, are these really the types of individuals whom Congress should protect?

Taking the case even further, the other type of investor most commonly found would be the highly sophisticated speculator.⁴⁴¹ This individual examines information concerning companies and, in effect, places his best reasoned guess on either their growth (when he buys), or the deterioration of their stock price (short sales). Essentially, his interest is not in the business itself, just its stock price.

It is estimated that twelve percent of the daily volume on the NASDAQ originates with so-called “day traders,” people who buy and sell shares hundreds of times a day on a purely speculative basis.⁴⁴² Is this a person whom Congress should protect? Such people undoubtedly have already made some money on the very stock in question but may have sold earlier than when the announcement of the news occurred. Indeed, day trading operations require deposits that start at no less than \$25,000. Is Congress in the business of maximizing the profits for speculators?

As Justices White and O'Connor stated in their dissent in *Basic Inc. v. Levinson*,⁴⁴³ “[h]ow a person who undertook such a speculative stock-investing strategy—and made [money per] share doing so—...can say that he was ‘defrauded’ by virtue of his reliance on the ‘integrity’ of the market price is beyond me. And such speculators may not be uncommon....”⁴⁴⁴ Essentially integrity has nothing to do with a stock's price—that number is a function of supply and demand.

Moreover, the concerns about extensive discovery, disruption of normal business activity and inability to prove actual damages would be enormous.

440. THE MUTUAL FUND FACT BOOK (1997); Kelleher, *supra* note 12.

441. Kelleher, *supra* note 11. In the early 1980s, the National Association of Securities Dealers established the small-order execution system, ostensibly to give “small” investors greater access to trading in the markets. With the advent of computer trading, dozens of companies in the United States have been created to cater to day traders, providing them with essential, real time market quotes and a system to execute orders instantly.

442. *Id.* “What we try to teach people is that in day trading, stocks aren’t stocks. They are four-letter symbol for making money.” “My mom calls it legalized gambling.” *Id.*

443. 485 U.S. 224, 250 (1988).

444. *Id.* at 261–62.

Frivolous lawsuits could be brought whenever someone could claim either that I "would have bought or sold" if I had known all of the same information, or I would have made even more money.

One might further ask whether it is possible that a person who is not even a "contemporaneous trader" can be injured in some direct way by insider trading? The House Committee Report on §20(A) suggests that it is:

In the view of the Committee, § 10(b), Rule 10b-5, and other relevant provisions of the Exchange Act have sufficient flexibility to recognize and protect any person defrauded or harmed by a violation of any provision of this title or the rules or regulations thereunder by another person's purchasing or selling a security while in the possession of material, nonpublic information, or communicating such information to others.⁴⁴⁵

In the view of the Committee, it was also important to note that...the potential harm to the plaintiff from the defendant's insider trading or tipping may be far greater than the profit gained or loss avoided by that defendant. The Committee recognizes that where the plaintiff demonstrates that he was defrauded by the defendant's insider trading and suffered actual damages proximately caused by the defendant's behavior, a cap of profit gained or loss avoided by the defendant, which is applicable for actions by contemporaneous traders, is not appropriate. Rather, in such an implied private cause of action, the plaintiff should be able to recover the full extent of those actual damages.⁴⁴⁶

This legislative intent, if followed, could dramatically expand individual litigation in this area, with its attendant speculative components of proof and damages.⁴⁴⁷

445. The most prominent example of the non-contemporaneous trader suit which came to the attention of the Committee involved a suit filed by Anheuser-Busch Companies, Inc. against Paul Thayer, a former director of the corporation. *See* Anheuser-Busch Companies, Inc., v. Thayer, CA3-85-0794-R (N.D. Tex. 1986). In that case, the plaintiff alleged that it was defrauded not as a result of trading with the defendant, but by having information secretly stolen and by having the subsequent trading on the information concealed. According to the complaint in this case, prior to public dissemination, the tipper disclosed to several parties the plans of Anheuser-Busch to acquire Campbell Taggart, Inc. The alleged misappropriation of Anheuser-Busch's confidential information proximately caused a significant increase in the market price of Campbell Taggart stock before Anheuser-Busch announced its offer. This forced Anheuser-Busch to raise its tender offer price, and the company eventually paid approximately \$80 million more as a result of the illegal insider trading. Clearly, in such a case, the plaintiff corporation was a victim of the defendant's misappropriation. In the view of the Committee, where the plaintiff can prove that it suffered injury as a result of the defendant's insider trading, the plaintiff has standing to sue in this circumstance, and the remedial purposes of the securities laws require recognition of such an action.

446. H.R. Rep. No. 100-910 at 11, 27 (1988), *reprinted at* 1988 U.S.C.C.A.N. 6043.

447. On the other hand, in *Feldman v. Motorola, Inc.*, 1994 WL 722883 (N.D. Ill.), the court reached the opposite conclusion, stating that "By limiting actions under § 20A,...Congress deliberately created a narrow cause of action." *Id.* at * 2.

By comparison, under the Securities Act of 1933,⁴⁴⁸ Congress did not charge the SEC with interpreting registration statements for prospective investors. Its only objective is to require "full and fair disclosure."⁴⁴⁹ The individual buyers have to make up their own minds. A similar philosophy should apply here.

As Justice Rehnquist lamented in *Blue Chip*,⁴⁵⁰ "it would be disingenuous to suggest that either Congress in 1934 or the Securities and Exchange Commission in 1942, foreordained the present state of the law with respect to Rule 10b-5." What has happened since has exacerbated the problem.

Just eight years before *Blue Chip*⁴⁵¹ in the landmark *Texas Gulf Sulphur*⁴⁵² case, Judge Friendly, in his concurring opinion, stated in relevant part:

If we were writing on a clean slate, I would have some doubt whether the framers of the Securities Exchange Act intended § 10(b) to provide a remedy for an evil that had long been effectively handled by derivative actions for waste of corporate assets under state law simply because in a particular case the waste took the form of a sale of securities."⁴⁵³

Sadly, Justice Rehnquist's oft quoted statement: "When we deal with private actions under Rule 10b-5, we deal with a judicial oak which has grown from little more than a legislative acorn,"⁴⁵⁴ has come to pass.

5. A Final Comparative Look at § 16

Ironically, Congress gave a poor answer on this question of the identity of possible plaintiffs under its § 16(b)⁴⁵⁵ guidelines. There, the statute provides that a suit to recover the profits can be instituted by the issuer (corporation) "or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within 60 days after request...."⁴⁵⁶

What has happened with that statute since is virtual champerty. The plaintiff need not even own the shares at the time of the defendant's insider trading under § 16(b). He only needs to own one share at the time the suit is filed. More expansively, Justice Souter, writing for the court in *Gollust v. Mendell*,⁴⁵⁷ stated that the plaintiff need not even own that share at the time of trial when that share no longer exists because another company purchased all the shares, so long as the person owns a share in the new parent company. However, he still had to own the original share at the time the suit was initiated.

448. 15 U.S.C. §§ 77a-77aa (1994).

449. *Id.*

450. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

451. *Id.*

452. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

453. *Id.* at 865 n.1.

454. *Blue Chip Stamps*, 421 U.S. at 737.

455. 15 U.S.C. § 78p(b) (1994).

456. *Id.*

457. 501 U.S. 115 (1991).

Who benefits from such cases? Certainly not the corporation, which has either chosen not to file a derivative suit or has no particular interest in the matter. Certainly not the plaintiff-owner of one particular share, who probably never heard of the issuer before being told by his counsel to buy it, well after the defendant's trades occurred.⁴⁵⁸ Moreover, it is not even necessary to actually resort to litigation in order to earn the fee. In most cases lawyers receive a quarter to a third of the entire recovery. This is not a class action situation where all the shareholders benefit or one in which a fine is paid to the SEC for the benefit of society.⁴⁵⁹ Such a tragic state of the law does nothing but further the public's already significantly negative image of lawyers and their unnecessary litigation, and, itself, calls for legal reform. To extend this rationale to Rule 10b-5 cases and allow speculator plaintiffs with hypothetical transactions to sue tippees on a misappropriation theory would make a further mockery of the system.

6. *The Rationale Is Available*

The Supreme Court has already stated that

If Congress had legislated the elements of a private cause of action for damages, the duty of the judicial branch would be to administer the law which Congress enacted;....[b]ut as we have pointed out we are not dealing here with any private right created by the express language of § 10(b) or of Rule 10b-5. No language in either of those provisions speaks at all to the contours of a private cause of action for their violation.... We are dealing with a private cause of action which has been judicially found to exist and which will have to be judicially delimited one way or another unless and until Congress addresses the question.⁴⁶⁰

The SEC will continue to bring its criminal and civil actions on the theories already enunciated by the court. Likewise, if there is privity or some direct relationship between the plaintiff and defendant, recovery should be allowed.⁴⁶¹

458. In *Magida v. Continental Can Co.*, 231 F.2d 843 (2d Cir. 1956), where certiorari again was denied, 351 U.S. 972 (1956), the Second Circuit Court refused to allow a defense of champerty even though the plaintiff's pro rata share of recovery amounted to only \$1.10. Plaintiff's attorney received virtually all of a large award.

459. § 21D(a)(6) of the 1934 Act, added by the Reform statute, provides: "(6) Restriction on Payment of Attorneys' Fees and Expenses. Total attorneys' fees and expenses awarded by the court to counsel for the plaintiff class shall not exceed a reasonable percentage of the amount of any damages and prejudgment interest *actually paid to the class.*" 15 U.S.C. § 78u-4(a)(6) (Supp. 1996) (emphasis added). No interpretation of this language has yet to be made judicially.

460. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 748 (1975).

461. The states have particularly stated that they do not accept the "fraud on the market theory" in many jurisdictions. To do otherwise would simply perpetuate the regrettable circumstances of the § 16(b) identity of the plaintiff. In *Mirken v. Wasserman*, 858 P.2d 568 (1993), the California Supreme Court refused to accept the "fraud on the marketplace" theory in its state securities fraud case, and in *Lindner Fund, Inc., v. Waldbaum, Inc.*, 624 N.E.2d 160 (1993), the New York Court of Appeals held that the tender offerors did not have a "duty of public disclosure upon reaching agreement in

The misappropriation theory as defined by the court in *O'Hagan*⁴⁶² requires a "breach of duty" to the source of the critical information. This test, however, creates no specific duty on the part of a trading defendant to some individual, fractional shareowner of a mutual fund held in street name. More clearly, such defendants as tippee-traders and those who allegedly aid and abet trades based on misappropriated information have no identifiable duty to such an anonymous plaintiff.

The "fraud on the marketplace" theory applied by the Supreme Court to corporate conduct also is not appropriate in such a case. Identified in Justice Blackmun's plurality opinion in *Basic Inc. v. Levinson*,⁴⁶³ the phrase was not used in *Central Bank*⁴⁶⁴ or any other subsequent cases and should be rejected now. The rationale has been rejected by the California Supreme Court, the most active state jurisdiction in the field.⁴⁶⁵ Blackmun's rationale stands as an isolated view in a plurality holding; the product of an arithmetic aberration in the court's composition. Justice Ginsburg's statement in *O'Hagan* that scienter is still essential to find culpability should finally suffice to abrogate the "fraud on the marketplace" doctrine.

Language also exists in *O'Hagan* to preclude such private causes of action on a misappropriation theory against individual defendants with whom they had no direct dealing. Quoting *Chiarella*, Justice Ginsburg said that § 10(b) liability "is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."⁴⁶⁶ Moreover, she reminded, "[t]here is under § 10(b), we explained, no general duty between all participants in market transactions to forgo actions based on material nonpublic information. Under established doctrine, we said, a duty to disclose or abstain from trading arises from a specific relationship between two parties."⁴⁶⁷

It would seem then that support for the limitations on private causes of action argued herein can be based upon an interpretation of the *O'Hagan* language: "These statements rejected the notion that § 10(b) stretches so far as to impose a general duty between all participants in market transactions to forgo actions based on material, nonpublic information,"⁴⁶⁸ and we confine them to that context.⁴⁶⁹

Relying at some length on the Eighth Circuit's "misreading" of *Central Bank*, the majority noted that that opinion's reference to purchasers or sellers of securities had to be viewed in terms of the Supreme Court's longstanding restriction on private § 10(b) litigation. Citing historic rulings on this point from as

principle on the acquisition," both direct rejections of Justice Blackmun's plurality opinion in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

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

463. 485 U.S. 224 at 241.

464. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994).

465. See *Mirkin*, 858 P.2d at 571, 572.

466. *O'Hagan* 117 S. Ct. at 2212 (quoting *Chiarella v. U.S.*, 445 U.S. 222, 230 (1980)).

467. *Id.* at 2211-12 (quoting *Chiarella*, 445 U.S. at 233).

468. *Id.* at 2212 (quoting *Chiarella*, 445 U.S. at 233).

469. *Id.*

far back as *Blue Chip Stamps*, Justice Ginsburg referred to such major "policy" considerations as "the abuse potential and proof problems inherent in suits by investors who neither bought nor sold, but asserted they would have traded absent fraudulent conduct by others."⁴⁷⁰

It is submitted here that this rationale should be applied to those who, conversely, would claim in a private civil suit that they would not have traded had they known of the defendant's fraudulent trade based upon his misappropriation of nondisclosed material information.

The lengthy dissent of Justices White and O'Connor in the *Basic Inc. v. Levinson*⁴⁷¹ case speaks on this point as well. That plurality decision,⁴⁷² the dissenting Justices believed, hopefully rejected the "recovery by a plaintiff who claims merely to have been harmed by a material misrepresentation which altered the market price notwithstanding proof that the plaintiff did not in any way rely on that price."⁴⁷³ One can rebut such evidence, but the burden is enormously difficult. "[The plurality's]... 'presumption of reliance' also assumes that buyers and sellers rely—not just on the market price—but on the 'integrity' of that price. It is this aspect of the fraud on the market hypothesis which most mystifies me."⁴⁷⁴

This view that there is no real integrity of a market price, has been supported by many, since "[i]ndeed many investors purchase or sell stock because they believe the price inaccurately reflects the corporation's worth"⁴⁷⁵ and seek to take advantage of that point. The price of a stock is simply a function of its demand and supply—for whatever honorable or dishonorable reasons.

To expand the category of plaintiffs means that:

Such investors, the savviest of the savvy, will be able to recover under the Court's opinion, as long as they now claim that they "believed in the integrity of the market price" when they sold their stock.... I suspect that all too often the majority's rule will "lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers." This Court and others have previously recognized that "inexorably broadening...the class of plaintiff[s] who may sue under this theory of law will ultimately result in more harm than good."⁴⁷⁶

470. *O'Hagan*, 117 S. Ct. at 2213.

471. 485 U.S. 224 (1988).

472. See Justice Powell's opinion in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), for a less than subtle sarcastic characterization of the binding effect of plurality opinions.

473. *Basic*, 485 U.S. at 251.

474. *Id.* at 255.

475. *Id.* at 256. See Barbara Black, *Fraud on the Market: A Criticism of Dispensing With Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 455 (1984); Strauss & Fishbone, *supra* note 5, at 374; Salbu, *supra* note 5; see also Hazen, *supra* note 5, at 597.

476. *Basic*, 485 U.S. at 262 (second ellipse and brackets in original) (citation omitted).

With the SEC and courts ready to interpret *O'Hagan* in broader contexts, it is essential now to draw a line in the sand, allowing only the SEC or a party with a direct trading relationship to sue individual defendants under the misappropriation theory.

