The Misappropriation Theory of Insider Trading: Outside the Lines of Section 10(b)

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THE MISAPPROPRIATION THEORY OF INSIDER TRADING: OUTSIDE THE LINES OF SECTION 10(b)

I. INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 ("1934 Exchange Act") declares, "It shall be unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe . . . ." Insofar as this statutory provision for imposing insider trading liability is conspicuously simple in form, it has nonetheless been analogized to a "legislative inkblot," one whose language possesses "no intrinsic meaning but which must be plumbed for deeper consequence." Rule 10b-5, the "centerpiece of federal securities regulation," promulgated under section 10(b) and the Security and Exchange Commission's ("S.E.C.") administrative authority granted thereby, is no less enigmatic. Hence, with heightened S.E.C. enforcement of insider trading violations, judicial scrutiny of the proper scope

2. Joseph A. Grundfest, We Must Never Forget That It is an Inkblot We are Expounding: Section 10(b) as Rorschach Test, 29 Loy. L.A. L. Rev. 41 (1995).
3. Id.
4. 17 C.F.R. § 240.10b-5 (1996). The language of Rule 10b-5, which mirrors that of section 10(b), reads, in relevant part:
   It shall be unlawful for any person . . .
   (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.

5. SEC v. Clark, 915 F.2d 439, 450 (9th Cir. 1990).
7. From 1990 through 1995, the S.E.C. pursued an average of approximately forty-two insider trading cases annually, which, according to S.E.C. Enforcement Director William McLucas, was "substantially higher" in number than ten years earlier. Susan Jenkins, Lawyers Debate Future of Misappropriation Theory After Bryan, 27 SEC. REG. & L. REP. 1331, 1332 (1995); see also William R. McLucas and Alma M. Angotti, Insider Trading: Is It Back or Did It Ever Really Go Away?, 9 Insights 2 n.4 (1995) (noting the number of SEC prosecutions for insider trading violations during the years 1984 through 1994 were, to wit: 1984, 13; 1985,
accorded § 10(b) and, in turn, Rule 10b-5, has stirred emotions among even the most fastidious of legal observers.

The "misappropriation theory" of insider trading lies at the heart of the section 10(b) and Rule 10b-5 interpretational debate. Adored by market protectionists and criticized by "laissez-faire" advocates, the misappropriation theory has evolved into the S.E.C.'s preeminent prosecutorial weapon for combating fraudulent trading practices. In effect, the theory prohibits "an informational advantage [from being] obtained, not by superior experience, foresight or industry, but by some unlawful means;"\(^8\) that is, "st[ealing] to put it bluntly."\(^9\) More specifically, it renders one's nondisclosure of material\(^10\) nonpublic\(^11\) information a violation of section 10(b) and Rule 10b-5 if such information was obtained through a breach of any fiduciary duty and subsequently employed in conjunction with a securities transaction.\(^12\) Recently rejected in the Fourth\(^13\) and Eighth\(^14\) Circuits of the United States


9. Id. at 245.

10. In *TSC Industries, Inc. v. Northway, Inc.*, the Supreme Court articulated the "materiality standard," as follows:

   An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.


11. "Nonpublic" information constitutes any information to which all market participants do not have equal access. Seibert v. Sperry Rand Corp., 586 F.2d 949, 952 (2d Cir. 1978). Such information must be specific and more private than general rumor. United States v. Mylett, 97 F.3d 663, 666 (2d Cir. 1996) (citing SEC v. Monarch Fund, 608 F.2d 938, 942-43 (2d Cir. 1979)).

12. See United States v. Mylett, 97 F.3d 663, 666 (2d Cir. 1996); United States v. Chestman, 947 F.2d 551, 556, 570 (2d Cir. 1991). In *United States v. Willis*, the court explained the rationale underlying the misappropriation theory, as follows:

   The underlying rationale of the misappropriation theory is that a person who receives secret business information from another because of an established relationship of trust and confidence between them has a duty to keep that information confidential. By breaching that duty and appropriating the confidential information for his own advantage, the fiduciary is defrauding the confider who was entitled to rely on the fiduciary's tacit representations of confidentiality.


Courts of Appeals, and embraced within their Second,\textsuperscript{15} Seventh,\textsuperscript{16} and Ninth\textsuperscript{17} sister-circuits, the Supreme Court has yet to conclusively address whether the misappropriation theory belies section 10(b)'s strictures.\textsuperscript{18}

In the absence of a definitive Supreme Court decree, perhaps no more significant nor contentious an issue arises in securities law jurisprudence than the misappropriation theory's validity as a vehicle by which to impose section 10(b) liability. Its supporters vehemently assert that the broad theory is wholly consistent with section 10(b)'s scant legislative history. Indeed, congressional intent suggests that "effective regulation must include several clear statutory provisions reinforced by penal and civil sanctions, aimed at those manipulative and deceptive practices which have been demonstrated to fulfill no useful function\textsuperscript{19}" and which are "detrimental to the interests of investors.\textsuperscript{20}" On the contrary, critics find no authority for such an expansion of securities fraud liability. They denounce the misappropriation theory's liberal application of fiduciary concepts and subscribe to the Supreme Court's restrictive textual interpretation of section 10(b).

Although the misappropriation theory has enjoyed nearly one decade of federal court approval, the Fourth and Eighth Circuits, in \textit{United States v. Bryan}\textsuperscript{21} and \textit{United States v. O'Hagan},\textsuperscript{22} respectively, have recently rejected its legitimacy, thereby severely limiting the scope of section 10(b) liability in those jurisdictions. The S.E.C., despite \textit{Bryan} and \textit{O'Hagan}, strongly maintains the matter to be well-settled, and insists it will persist in invoking the theory among other circuits.\textsuperscript{23} Others warn against overstating the importance of \textit{Bryan}'s and \textit{O'Hagan}'s

\begin{thebibliography}{9}
\bibitem{16} \textit{See SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).}
\bibitem{17} \textit{See SEC v. Clark, 915 F.2d 439 (9th Cir. 1990).}
\bibitem{18} \textit{See Carpenter v. United States, 484 U.S. 19, 24 (1987) (explaining that "[t]he Court is evenly divided with respect to the convictions under the [misappropriation theory] and for that reason affirms the [the defendant's conviction]."); Chiarella v. United States, 445 U.S. 222, 235-36 (1980) (declining to address the misappropriation theory because "[t]he jury was not instructed on the nature or elements" of the theory); Bateman, Eichler, Hill, Richards, Inc. v. Berner, 472 U.S. 299, 313 n.22 (1985) (acknowledging in a footnote that the Court has "also noted that a tippee may be liable [under Rule 10b-5] if he otherwise misappropriate[s] or illegally obtain[s] the information.".).}
\bibitem{19} \textit{S. REP. No. 792, at 6 (1934).}
\bibitem{20} \textit{Id. at 18.}
\bibitem{21} 58 F.3d 933 (4th Cir. 1995).
\bibitem{22} 92 F.3d 612 (8th Cir. 1996), cert. granted, 117 S. Ct. 759, 136 L.Ed.2d 695 (1997).
\bibitem{23} \textit{See David E. Rovella, SEC Asserts Insider Trade Rule Still OK, NAT'L L. J., Sept. 4, 1995, at B1, col. 1.}
\end{thebibliography}
holdings, arguing that the vast majority of S.E.C. insider trading enforcement actions will nevertheless remain unaffected. Are Bryan and O’Hagan, as some suggest, merely “aberrational” cases, or do they portend a shift in judicial philosophy, one that the Supreme Court already holds evident, but upon which it has heretofore remained silent?

Seventeen years ago, Justice Stevens wrote of the misappropriation theory and its validity, “I think the Court wisely leaves the resolution of this issue for another day.” Ironically, the Supreme Court has since declined numerous opportunities to seize that day. While Bryan represented the first time the Court could have addressed a circuit split as to the theory’s legitimacy, no petition for certiorari was filed. Fortunately, the Government has appealed, and the High Court has chosen to consider, the Eighth Circuit’s decision in O’Hagan. Thus, with the misappropriation issue ripe for judicial review and a factually clear-cut case before the Court, the day of which Justice Stevens spoke shall soon arrive. Meanwhile, speculation resounds—will nine justices, or a majority thereof, ultimately bestow compassion upon the theory, or shall it be adjudged a doctrine whose day has come and gone?

This Comment shall objectively address, and attempt to answer, that very question. In doing so, Part II briefly explores the history of the misappropriation theory and insider trading generally. Part III then examines the Supreme Court’s textualist philosophy towards statutory interpretation and its treatment of section 10(b) and Rule 10b-5 in other securities contexts. Next, Part IV renders a prediction as to the theory’s future based on section 10(b)’s plain language, followed by Part V’s analysis of the implications and policy justifications underlying such a

24. See Jenkins, supra note 7, at 1331.
28. The reasons the Supreme Court will consider in granting a writ of certiorari include, “When a United States court of appeals has rendered a decision in conflict with the decision of another United States court of appeals on the same matter.” Sup. Ct. R. 10(a). As explained above, the Second, Seventh, and Ninth Circuits currently recognize the misappropriation theory’s validity, whereas the Fourth and Eight Circuits do not.
29. The term “clear-cut” is used to suggest that the Supreme Court could only find § 10(b) liability in the O’Hagan case based upon the misappropriation theory, and no other “insider trading” doctrine.
1997] MISAPPROPRIATION THEORY OF INSIDER TRADING 823

collection. Finally, Part VI summons Congress to legislatively curtail the confusion surrounding section 10(b) and Rule 10b-5 by codifying a definition of "insider trading."

II. THE HISTORICAL DEVELOPMENT OF INSIDER TRADING REGULATION AND THE MISAPPROPRIATION THEORY

A. The Legislative and Judicial Origins of Insider Trading Regulation

From the moment President Roosevelt emphasized the need for federal securities legislation that would prevent a recurrence of "the terrible conditions of the years following [the] 1929 [stock market crash]," the regulation of insider trading has developed as "a judicial oak which has grown from little more than a legislative acorn." Initially, the 1934 Exchange Act, which included numerous anti-fraud provisions that neither defined nor prohibited insider trading, sought to address illicit market practices via continuous reporting obligations and private section 16 actions. However, with the inability of those mechanisms to reach a growing range of trading abuses, section 10(b) and Rule 10b-5 were beckoned to fill the regulatory void. Although not specifically forbidding insider trading, section 10(b) and Rule 10b-5 have been judicially and administratively interpreted to encompass such activity. Early litigation generally implicated the activities of traditional insiders (directors, officers, and controlling shareholders), with liability premised on "strict common law duties of loyalty and trust" owed to corporations and their constituent owners.


For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner [of at least ten per centum of a corporation's equity securities], director, or officer by reason of his relationship to the issuer, any profits realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months... shall inure to and be recoverable by the issuer...  Id. Hence, section 16 does not actually define "insider trading." Rather, it establishes a very limited bright-line rule as to how directors, officers, and shareholders possessing greater than ten percent of a corporation's equity securities must conduct themselves.
33. COX ET AL., supra note 32, at 823.
Trading upon material nonpublic information without disclosure to one's fiduciary constituted a breach of the good faith relationship existing between those parties, as well as fraud or deceit within the meaning of Rule 10b-5. Clearly, however, insiders remained free to capitalize upon their informational advantages in open market exchanges. The securities laws have since evolved to reach impersonal transactions and, in doing so, abandoned those common law fiduciary principles in favor of broader policy-based considerations.


The S.E.C.'s 1961 decision in In re Cady, Roberts & Co. forged the way for the "modern" era of insider trading regulation. In that seminal case, the agency articulated the "disclose or abstain" rule: the duty of traditional insiders to "disclose material facts which are known to them by virtue of their position... prior to effectuating a purchase or sale" or, as an alternative, "to forego the transaction." Such disclosure ensures, for want of a better expression, a "level trading floor" between all market participants to whom the rule applies. Moreover, the S.E.C. recognized that persons other than corporate directors, officers, or controlling shareholders who obtained "tips" from traditional insiders assumed the same duty to "disclose or abstain." The result was unequivocal: section 10(b)-Rule 10b-5 liability reached even open market transactions.

36. Id. Although the meaning of the term "fiduciary duty" has escaped succinct definition, one might best describe it as an actual expectation of fair dealing due to the existence of a pre-existing trusting and confidential relationship. See, e.g., BLACK'S LAW DICTIONARY 626 (6th ed. 1990) (defining a fiduciary relationship as one "subsisting between two persons in regard to a business... of such a character that each must repose trust and confidence in the other and must exercise a corresponding degree of fairness and good faith.").

37. See COX ET AL., supra note 32, at 827 (citing D. LANGEVOORT, INSIDER TRADING REGULATION 37-49 (1990)). See also Geller v. Transamerica Corp., 53 F. Supp. 625, 630 (D. Del. 1943), aff'd, 151 F.2d 534 (3d Cir. 1945) (holding that "[t]rading [on the New York Stock Exchange] is free and open" and that there is "no reason why one trader should be required to furnish information to another trader.").


40. 40 S.E.C. at 911.

41. Id.

42. In Cady, Roberts & Co., the defendant was a stockbroker unaffiliated with the corporation, but the information on which he acted came from a director of the corporation. Id. at 912. The court stated that because the director could not have traded upon the information without disclosure, it was only logical to extend this same prohibition to persons who acquired the information from the director. Id.
violations.\textsuperscript{43}

The Supreme Court, in \textit{Dirks v. S.E.C.},\textsuperscript{44} judicially affirmed the \textit{Cady, Roberts} derivative duty concept. In effect, so-called "tippee liability" is imposed "when the [traditional] insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach."\textsuperscript{45} \textit{Dirks} also delineated the circumstances in which outsiders (e.g., underwriters, accountants, lawyers, and consultants) themselves owed fiduciary duties to corporate shareholders because of their "temporary" insider status.\textsuperscript{46}

While \textit{Cady, Roberts}, and \textit{Dirks} indisputably expanded the scope of insider trading liability, the Supreme Court, in \textit{Chiarella v. United States},\textsuperscript{47} exhibited judicial conservatism when it rejected the Second Circuit's sweeping contention that "[a]nyone—corporate insider or not—who regularly receives material non-public information may not use that information to trade in securities without incurring an affirmative duty to disclose."\textsuperscript{48} The defendant, Chiarella, was a "mark-up" man for

\textsuperscript{43} "We cannot accept... that an insider's responsibility is limited to existing stockholders and that he has no special duties when sales of securities are made to non-stockholders. This approach is too narrow. It ignores the plight of the buying public—wholly unprotected from the misuse of special information." \textit{Id.} at 913.

\textsuperscript{44} 463 U.S. 646 (1983).

\textsuperscript{45} \textit{Id.} at 660. To fall subject to § 10(b) liability, the tipper must also receive some type of personal benefit for the information he or she passes. In \textit{Dirks}, the Court explained that such benefits may take the form of a "reputational benefit," a "pecuniary gain," or "a gift of confidential information to a trading relative or friend." \textit{Id.} at 663-664.

\textsuperscript{46} \textit{Id.} at 655. The Supreme Court's rationale in \textit{Dirks} for recognizing a duty among "temporary" insiders introduced a "special confidential relationship" concept to § 10(b) jurisprudence:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to the information solely for corporate purposes... For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.

\textit{Id.} at 655 n.14. Thus, insider trading liability could reach outside the corporate fiduciary relationship to penalize even those persons who would otherwise owe no duty to the shareholders of the entity in whose securities they trade.

\textsuperscript{47} 445 U.S. 222 (1980).

\textsuperscript{48} \textit{Id.} at 231. The lower court's rule as to whom owed a duty to "disclose or abstain" was only slightly narrower than that one which was articulated in \textit{SEC v. Texas Gulf Sulphur Co.}, 401 F.2d 833, 848 (2d Cir. 1968), \textit{cert. denied}, 394 U.S. 976 (1969) (stating that "anyone in possession of material inside information must either disclose it to the investing public,
Pandick Press, a financial printer, and deduced names of target companies from documents he handled announcing corporate takeover bids.\textsuperscript{49} Without disclosing that knowledge, he purchased stock in those target companies and, once the attempted acquisitions were publicized, promptly sold his shares.\textsuperscript{50} In overturning Chiarella’s conviction, the Court declined to stretch the notions of duty and fraud beyond their traditional boundaries. The Court began by stating that “[nondisclosure] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction.”\textsuperscript{51} The existence of this duty is essential to making silence fraudulent within the meaning of section 10(b) and Rule 10b-5. The Court then explained, and very significantly so, that such a duty follows from “prior dealings” between buyers and sellers, and as such, it refused to recognize “a general duty between all participants in market transactions to forgo actions based on material, nonpublic information.”\textsuperscript{52} Thus, Chiarella established that, as a pre-requisite to violating the Cady, Roberts “disclose or abstain” rule, there must exist a fiduciary link between the alleged insider and those individuals with whom he or she trades.

The legal framework which Chiarella and Dirks established has become synonymous with what is now termed the “classical” theory of insider trading.\textsuperscript{53} In short, under the classical theory, any permanent or temporary employee who trades upon material nonpublic information in the securities of his or her employer-company violates section 10(b) and Rule 10b-5. Liability also arises if such a permanent or temporary employee passes “inside” information on to a third-party who, in turn, trades upon that information and confers a benefit to the tipper. As is readily apparent, the classical theory’s fundamental premise is that an “insider owes a fiduciary duty to the corporation’s shareholders not to trade on inside information for his personal benefit.”\textsuperscript{54}

\textsuperscript{49} Chiarella, 445 U.S. at 224. As a “markup man,” Chiarella’s responsibilities entailed selecting type fonts and page layouts for documents before they were type-set. United States v. Chiarella, 588 F.2d 1358, 1363 (2d Cir. 1978), cert. granted, 445 U.S. 222 (1980).

\textsuperscript{50} Chiarella, 445 U.S. at 224.

\textsuperscript{51} Id. at 230.

\textsuperscript{52} Id. at 233.

\textsuperscript{53} See SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990).

\textsuperscript{54} SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).
C. The Misappropriation Theory of Insider Trading: Chiarella and Beyond

Chiarella not only proved instructive in its dissertation on duty and its relationship to fraud within the meaning of section 10(b) and Rule 10b-5, but Justice Stevens’s concurrence introduced the misappropriation theory as a potential vehicle by which to impose insider trading liability:

The Court correctly does not address . . . whether the petitioner’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 . . . . [I]f we assume that petitioner breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted “a fraud or deceit” upon those companies ‘in connection with the purchase or sale of any security.’

In contrast to the “classical” framework established by Chiarella and Dirks, the theory does not mandate a fiduciary link with marketplace traders. Rather, simply because misappropriated information is employed in a transaction, the trade is deemed to be fraud “in connection with the purchase or sale of [a] security.” In other words, the breach of any duty owed to a misappropriatee is effectively transposed unto the market at large—no duty to “abstain or disclose” need be owed the individual to whom the misappropriator sells securities, or from whom he purchases them. Although a majority of the Chiarella Court declined to consider the misappropriation theory’s merits, the Second Circuit, in United States v. Newman, soon thereafter endorsed its

55. Chiarella, 445 U.S. at 328. (Stevens, J., concurring). Chief Justice Burger, in his dissenting opinion, articulated a broader variation of the misappropriation theory, one to which the SEC and federal courts have not adhered. He stated: “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.” Id. at 240 (Burger, C.J., dissenting).

56. As noted above, the Chiarella-Dirks “classical” framework may best be described as a traditional, nontraditional, or constructive insider’s duty to “disclose or abstain” from trading on material nonpublic information obtained via a breach of fiduciary or similar trusting relationship. The insider may only be subject to liability for conducting transactions with persons to whom he or she owes such a duty (e.g., those individuals with whom he or she possesses a fiduciary or similar trusting relationship).


validity. The Supreme Court has twice indecisively addressed the theory in *Bateman, Eichler, Hill, Richards, Inc. v. Berner* and *Carpenter v. United States.*

*Carpenter,* a case which presented the Supreme Court with a story more apt to have originated in a Hollywood script than on Wall Street’s trading floor, provides a wonderful illustration of the misappropriation theory’s breadth in practice. Petitioner Winans was a co-author of the *Wall Street Journal*’s investment advice column, “Heard on the Street,” which, because it was widely read and respected, impacted the market prices of stocks it discussed. Although he was familiar with the *Journal*’s rule that the contents of “Heard” were to remain confidential prior to publication, Winans nonetheless furnished details concerning the timing and substance of upcoming columns to petitioners Felis and Brant, two stockbrokers, both of whom thereafter traded on the advance information. In exchange for his “tips,” Winans received a share of the brokers’ profits. A divided Second Circuit panel affirmed the defendants’ convictions under section 10(b) and Rule 10b-5, holding that Winans had committed fraud on the *Journal* by misappropriating its “confidential schedule of forthcoming publications” and exploiting that information “in connection” with trading activity. On review, the Supreme Court disposed of the misappropriation issue without addressing its merits, stating: “The Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgement below on those counts.”

While it is uncertain whether *Carpenter* left the misappropriation theory “alive and well” or “a fairly dubious proposition,” there

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59. 472 U.S. 299, 313 n.22 (1985) (quoting Dirks v. SEC, 463 U.S. 646, 665 (1983)) (stating that the Justices “also have noted that a tippee may be liable [under Rule 10b-5] if he otherwise ‘misappropriate[s] or illegally obtain[s] the information’”). However, because the significance of this dictum is unclear and the misappropriation theory was not directly at issue, this Comment will not discuss the case at length. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 836 (3d ed. 1995).


61. *Id.* at 22.

62. *Id.* at 23.

63. *Id.* The net profits from the brokers’ trades amounted to $690,000 over that four-month period during which Winans provided the prepublication information. *Id.*


65. *Id.* at 1032.


exists little doubt that the doctrine holds tremendous promise to reach a wide variety of trading abuses.\textsuperscript{69} Simply stated, the theory goes outside the Chiarella-Dirks "classical" framework to reach trades in a company's securities by individuals who are neither permanent nor temporary employees of that company (e.g., individuals who owe no duty to the company in whose securities he or she trades), as well as tippees of those parties. It not only imposes liability where conduct smacks of illegality, but fills regulatory gaps in which the "classical" abstain or disclose rule provides no remedy.\textsuperscript{70} Indeed, "[w]ithout the aid of the misappropriation theory, section 10(b) and [R]ule 10b-5 would lose much of their efficacy as weapons against trading on nonpublic information . . . ."\textsuperscript{71} Notwithstanding its functionality, however, the theory's validity has been called into question. Insofar as section 10(b) prohibits one's use of deception to induce another's action or inaction in open market exchanges, the misappropriation theory criminalizes breaches of fiduciary duty and other confidential relationships, irrespective of their tenuous connection to the disputed securities transaction. Thus, the issue is one of interpretational debate: does the theory, as originally espoused in Chiarella,\textsuperscript{72} truly capture "deception," or has it extended the term's meaning beyond the plain language of section 10(b). Supreme Court scrutiny of that provision in other contexts, as well as the Court's judicial philosophy towards statutory construction, clearly suggests the latter.

III. SUPREME COURT SCRUTINY OF SECTION 10(B) AND ITS CONTEMPORARY PHILOSOPHY TOWARDS STATUTORY INTERPRETATION

Few statutes better epitomize legislative imprecision than section 10(b). It embodies language subject to multiple interpretations, provides little basis for guiding statutory construction, and invites meaning where none seemingly exists. Whether calculated or by

\textsuperscript{68} Donovan, Supreme Court Upholds Convictions of Former Business Writer Winans, INVESTOR'S DAILY, Nov. 17, 1987, at 1, col. 4 (quoting Alan Bromberg, Professor of Securities Law at Southern Methodist University).

\textsuperscript{69} SOLOMAN ET AL., supra note 39, at 978.

\textsuperscript{70} Id. In SEC v. Cherif, the Seventh Circuit explained that the misappropriation theory, "extends the reach of Rule 10b.5 to outsiders who would not ordinarily be deemed fiduciaries of the corporate entities in whose stock they trade." SEC v. Cherif, 933 F.2d 403, 409 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992).


\textsuperscript{72} See supra notes 55-58 and accompanying text.
administrative neglect, Rule 10b-5 exhibits similar characteristics. Indicative of the fact that, since 1986, incidences of 5-4 decisions in Supreme Court cases interpreting federal securities laws have been threefold the overall docket average,73 neither Congress nor the S.E.C. has drafted succinct rules of conduct. In light of such ambiguity, the misappropriation theory may very well be more a product of judicial confusion than activism.

A. What Congress Said, Not What it Meant: Supreme Court Textualism in the 10(b) Context

Principles of statutory interpretation define boundaries among legislative expanse. Innumerable canons of construction have been contrived for doing so,74 many of which, although bearing different labels, yield like results. In contrast, the Supreme Court’s treatment of section 10(b) incorporates a markedly distinct textual, or “plain meaning,” interpretational methodology. Just as Justice Holmes once professed to be solely concerned with “what Congress said, and not what it meant,”75 the Court has largely limited itself to a literal reading of section 10(b). Such a straightforward approach largely ignores historical, moral, and policy considerations to effectuate legislative intent.76 Rather, it probes a statute’s text and structure for meaning.77 Because the Court’s textual interpretation of section 10(b) holds undeniable implications for insider trading regulation via the misappropriation theory, its understanding warrants further colloquy.

“For almost two decades, the Supreme Court has repeatedly warned against reading”78 the 1934 Exchange Act “more broadly than its language and . . . statutory scheme reasonably permit.”79 The following

73. Grundfest, supra note 2, at 50.
74. There are essentially three main statutory interpretational theories which emphasize either: “(1) the actual or presumed intent of the legislature enacting the statute (‘intentionalism’); (2) the actual or presumed purpose of the statute (‘modified intentionalism’); or (3) the literal commands of the statutory text (‘textualism’).” William N. Eskridge, Jr. & Phillip P. Frickey, Statutory Interpretation as Practical Reasoning, 42 STAN. L. REV. 321, 324 (1990).
discussion, in retracing the history of section 10(b) jurisprudence as set forth in *Central Bank of Denver v. First Interstate Bank of Denver*, reveals that challenges to conduct left unaddressed by the text of section 10(b) have been, at best, futile. To illustrate, in *Ernst & Ernst v. Hochfelder*, the Court considered whether section 10(b) mandated scienter as a prerequisite to liability, thereby relegating negligent behavior outside the antifraud provision's reach. Despite evidence of contrary congressional intent, the Court declined to "add a gloss to the operative language of the statute quite different from its commonly accepted meaning" and, therefore, concluded that section 10(b) could not "be read to impose liability for negligent conduct alone."

Only one term later, *Santa Fe Industries, Inc. v. Green* affirmed the *Ernst & Ernst* interpretational axiom. The case was one in which Kirby Lumber Corporation's minority shareholders protested a freeze-out merger initiated by Kirby's parent, Santa Fe, alleging that Santa Fe fraudulently appraised Kirby stock in an effort to squeeze out the minority at an undervalued price. While the Supreme Court acknowledged legislative history and policy concerns in concluding that a majority's breach of fiduciary duty, absent any misrepresentation or failure to disclose, did not contravene section 10(b), it emphasized the statute's "language ... [as] giv[ing] no indication that Congress meant to prohibit any conduct not involving manipulation or deception." As will be seen, *Santa Fe Industries'* substantive holding takes on added significance in evaluating the misappropriation theory's validity.

Perhaps the starkest display of textualism is manifested in *Central Bank v. First Interstate Bank* itself, a recent Supreme Court case addressing aiding and abetting liability under section 10(b) and Rule 10b-

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81. See id. at 173 (explaining that the Supreme Court has "refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute.").
84. Ernst & Ernst, 425 U.S. at 201.
86. Id. at 465-68.
87. See id. at 477-79 (explaining that the Court's recognition of an implied cause of action for respondent's alleged breach of fiduciary duty would not fulfill congressional intent and would pose a danger to vexatious litigation).
89. 511 U.S. 164 (1994).
5. Following the Colorado Springs-Stetson Hills Public Building Authority's default on bonds over which Central Bank served as indenture trustee, purchasers of the securities brought suit against numerous parties, including Central Bank as an "aider and abettor," for violating section 10(b). Prior to Central Bank, secondary liability was by no means a novel nor overlooked concept among federal courts. However, Santa Fe Industries and Ernst & Ernst had engendered doubt as to its continued existence. The Court's methodical analysis in Central Bank proved true to precedent. Aiding and abetting liability under Rule 10b-5 was an issue to be resolved on textual bases, not policy considerations. "With respect . . . [to] the scope of conduct prohibited by section 10(b), the text of the statute control[led the] decision." Because "the text of the 1934 Act does not itself reach those who aid and abet a section 10(b) violation" and "[i]t is inconsistent with settled methodology in section 10(b) cases to extend liability beyond the scope of conduct prohibited by the statutory text," the Court overturned Central Bank's

90. The Court of Appeals for the Tenth Circuit articulated the elements of a section 10(b) "aiding and abetting action" as: "(1) the existence of a primary violation of the securities laws by another; (2) knowledge of the primary violation by the alleged aider-and-abettor; and (3) substantial assistance by the alleged aider-and-abettor in achieving the primary violation." First Interstate Bank of Denver, N.A. v. Pring, 969 F.2d 891, 898 (10th Cir. 1992).

91. Central Bank of Denver, 511 U.S. at 166-67. "In 1986 and 1988, the Colorado Springs-Stetson Hills Public Building Authority (Authority) issued a total of $26 million in bonds to finance public improvements at Stetson Hills." Id. Central Bank served as indenture trustee for the bond issues, which were secured by landowner liens and included covenants requiring: (1) that the land subject to the liens maintain a "worth at least 160% of the bonds' outstanding principal and interest;" and (2) that AmWest Development, developer of Stetson Hills, "give Central Bank an annual report containing evidence that the 160% test was met." Id. "In January 1988, AmWest provided Central Bank [with] an updated appraisal of the land proposed to secure the 1988 bonds"; the appraisal showed that the land values were unchanged from the 1986 appraisal. Id. After Central Bank's in-house appraiser determined that the values listed in the appraisal appeared optimistic, he suggested obtaining independent review. Id. at 168. "Before the independent review was complete, however, the Authority defaulted on the 1988 bonds" and Central Bank was alleged "secondarily liable under § 10(b) for its conduct in aiding and abetting the fraud." Id.


93. See Central Bank of Denver, 511 U.S. at 169-70, for examples of courts and commentators calling aiding and abetting liability under § 10(b) into question.

94. See Central Bank of Denver, 511 U.S. at 172-78.

95. Eisenberg, supra note 76, at 20 (quoting Central Bank of Denver, 511 U.S. at 172).
conviction.\footnote{Id. (quoting Central Bank of Denver, 511 U.S. at 177-78).}

At first blush, Central Bank's blatant disregard for legislative intent appears indefensible. Even the vaguest of doctrines, our Constitution, routinely implores judicial interpretation in light of historical and social context. Section 10(b), however, is distinguishable on three grounds. First, the statute is bereft of any explicit original intent.\footnote{S. Rep. No. 792, at 18 (1934).} The Senate Report specifically addressing section 10(b) merely conveyed a purpose of "prohibit[ing] or regulat[ing] the use of any other manipulative or deceptive practices which [the S.E.C.] finds detrimental to the interests of the investor."\footnote{Grundfest, supra note 2, at 44 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 201 (1976)).} Second, section 10(b)'s critical insider trading terminology (e.g., "deception"), unlike the language of the Constitution, is not open to whimsical judicial interpretations. For example, whereas the Supreme Court has from time to time either expanded or restricted the malleable definition of "interstate commerce" in the face of social and political change, "deception" is a linguistic constant.\footnote{See infra note 118 and accompanying text.} And third, Congress never sought to develop a civil remedy for section 10(b) violations.\footnote{Grundfest, supra note 2, at 45.} It is, therefore, imprudent to criticize Central Bank's textual holding without recognizing that the private right of action is as empty as the origins from which it arose.\footnote{Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 175 (1994).}

\textbf{B. Textual Interpretations of Other Securities Provisions}

Strict adherence to statutory language is largely consistent with the Supreme Court's interpretation of other securities provisions.\footnote{486 U.S. 622 (1988).} For example, in \textit{Pinter v. Dahl},\footnote{Central Bank of Denver, 114 S. Ct. at 1447 (quoting Pinter v. Dahl, 486 U.S. 622, 641 (1988)). Section 12(1) of the 1933 Securities Exchange Act, 15 U.S.C. § 77l(1), provides, in relevant part: Any person who . . . offers or sells a security in violation of section [5] . . . shall be liable to the person purchasing such security from him, who may sue . . . to recover}
and, reminiscent of Central Bank, explained that "[t]he ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section."¹⁰⁵

But intentionalism is not altogether extinct. An exception to textual interpretation apparently exists where legislative history clearly fills gaps within a statute's four corners. Gustafson v. Alloyd Co., Inc.,¹⁰⁶ a case wherein the Supreme Court considered whether recisionary rights under section 12(2) extended to secondary transactions, exemplifies this departure from "plain meaning" analysis. There, purchasers of Alloyd Co. stock sought the recision of a private sale agreement with previous shareholders on the premise that the contract constituted a section 12(2) "prospectus" which contained material factual misrepresentations.¹⁰⁷ While Gustafson's dissenting opinion voiced allegiance to textualism, the Court majority, resting its decision predominantly on congressional intent, concluded:

The House Report ... states with clarity and with specific reference to section 12 that section 12 liability is imposed only as to a document soliciting the public .... In light of the care that Congress took to justify the imposition of liability without proof of either fraud or reliance on "those whose moral responsibility to the public is particularly heavy"—the "originators of securities"—we can not conclude that Congress would have extended that liability to every private or secondary sale without a whisper of explanation.¹⁰⁸

Gustafson should not, however, be read as an absolute shift in interpretational philosophy, for distinct traces of "plain meaning" analysis echo

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the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security.

Section 5 of the 1933 Act, 15 U.S.C. § 77e, referred to above in section 12(1), generally speaking, makes it unlawful to sell or deliver an unregistered security in interstate commerce.

105. Central Bank of Denver, 114 S.Ct. at 1447 (quoting Pinter, 486 U.S. at 653)).


107. Id. at 1064. Section 12(2) of the 1933 Securities Exchange Act, provides, in relevant part, that one who:

offers or sells a security ... by means of a prospectus ... which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading ... shall be liable to the person purchasing such security from him ... to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon ....


throughout the entire decision. For example, well before even consider-
ing legislative history, the Court explained that the term “prospectus” 
was to be determined “by a reexamination of section 12 itself” and 
resort to the texts of sections 2(10) and 10 of the 1934 Act. Moreover, 
Gustafson’s justification for probing congressional intent—the 
existence of a clear legislative record—is inapplicable to construing section 10(b). Unlike section 12, section 10(b) is a regulatory tool without 
assembly instructions. When a manufacturer fails to furnish directions 
for the assembly of its product, one must examine the parts given him 
and, through trial and logic, interchange them until an end-product is 
fashioned. Likewise, the Court has been careful to work only with those 
section 10(b) parts Congress has provided, and for want of legislative 
guidance, assembled every one of them based upon their outward 
appearance and textual interrelationships.

C. A Standard for Guiding Future Section 10(b) Interpretations

A comprehensive framework for guiding statutory construction may 
be distilled from the foregoing discussion. Simply stated, absent a well-
articulated legislative record specifically addressing the provision and 
question at issue, which is clearly not the case with respect to insider 
trading under section 10(b), textualism directs judicial interpretation of 
the securities laws. Although remnants of the activist Warren era 
(e.g., implied rights of action) shall continue to influence Supreme Court 
decisions, “plain meaning” analysis will undoubtedly shape contemporary 
securities jurisprudence, much as it has done for twenty years. Suggest-
ing otherwise would be to reject stare decisis, the most fundamental of 
judicial principles under our common law system.

Textualism holds tremendous value for predicting future Supreme 
Court interpretations of the 1934 Act. Conduct of which the statute’s 
language does not speak is unactionable, that is, what you see is what 
you get. The misappropriation theory’s future thus lies within sec-
tion 10(b)’s four corners.

IV. THE FUTURE OF THE MISAPPROPRIATION THEORY IN LIGHT OF 
SUPREME COURT TEXTUALISM

To foretell the misappropriation theory’s fate is a linguistical exercise.

109. Id. at 1067.
110. See id. at 1066-68.
111. See supra notes 106-110 and accompanying text.
Every word within section 10(b) and Rule 10b-5 possesses a definition to which the Supreme Court strictly adheres. A synthesis of those meanings yields the limits of prohibited conduct. But where is that boundary, and more importantly, does the misappropriation theory lie within or without it? The following discussion, in answering these questions and drawing upon United States v. Bryan and United States v. O'Hagan, anticipates an analysis similar to one the Court might undertake.

A. The Textual Parameters of Section 10(b) Liability

Recognizing that "[t]he starting point in every case involving construction of a statute is the language itself," it is necessary to reiterate the pertinent texts of section 10(b) and Rule 10b-5. The former reads, in relevant part:

It shall be unlawful for any person, directly or indirectly . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.113

The latter provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . [t]o 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 a security.114

Initially, then, manipulation and deception lie at the heart of section 10(b) liability.115 However, because "manipulation" is a "term of art [with]in the securities context," principally directed towards practices frustrating market efficiency,116 its interpretation is irrelevant to assessing the misappropriation theory's validity. Rather, "deception" alone carries the burden of regulating insider trading. To the extent that

113. 15 U.S.C. § 78j(b) (emphasis added).
114. 17 C.F.R. § 240.10b-5 (emphasis added).
116. Id. (citing SantaFe Industries, Inc., 430 U.S. at 476 (explaining that manipulation references activities "such as wash sales, matched orders, or rigged prices," that are "intended to mislead investors by artificially affecting market activity.") (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976))).
the S.E.C.'s exercise of administrative authority may not exceed its statutory grant, logic dictates that a claim of "fraud" under Rule 10b-5 is actionable only if it can be viewed as "deceptive" within section 10(b)'s meaning.117

While "deceit" and "fraud" are veritable synonyms outside the realm of insider trading regulation, they receive dissimilar treatment within it. The interpretation accorded "deception" is refreshingly straightforward and uncontroversial. In Sante Fe Industries, Inc. v. Green,118 the Supreme Court defined that term as one's material misrepresentation or nondisclosure of information, to induce another's action or inaction, in violation of a duty to disclose. Central Bank v. First Interstate Bank has since affirmed this construction.119 On the other hand, "fraud" implicates mere breaches of duty and fiduciary relationships. Recall that Chiarella v. United States premised actionable fraud upon one's silence in contravention of his or her obligation to disclose.120 However, a general duty to speak does not exist among all market participants—it is only bestowed upon those persons with whom buyers and sellers of securities possess a trusting and confidential relationship.121

It is readily apparent that deceit and fraud do not occupy an all-encompassing common ground, for the latter may exist where the former does not. In other words, fraud is a broader concept than deceit. Of course, deceptive conduct will always trigger section 10(b) liability. The converse, however, is a non sequitur. A claim of fraud and fiduciary breach, standing alone, is not sustainable.122 Deception must also

117. As articulated in Ernst & Ernst, the language of Section 10(b) must control the interpretation of Rule 10b-5, for:

Rule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is the power to adopt regulations to carry into effect the will of Congress as expressed by the statute . . . . [T]he scope of Rule 10b-5 cannot exceed the power granted the Commission by Congress under § 10(b). (Citations omitted).

Ernst & Ernst, 425 U.S. at 212-14.


119. "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or commission of a manipulative act." Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177 (1994) (citing Sante Fe Indus., 430 U.S. at 473; Ernst & Ernst, 425 U.S. at 214).

120. See supra text accompanying note 51-52.

121. See supra text accompanying note 51-52.

122. See Bryan, 58 F.3d at 946 ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement-
underlie the transaction.

A cursory review of section 10(b) and Rule 10b-5 reveals that both provisions require prohibited conduct to be "in connection with the purchase or sale of any security." The Supreme Court's original interpretation of this phrase, articulated in Superintendent of Ins. v. Bankers Life & Casualty Co.,123 has spurred significant controversy. Justice Douglas wrote, "[the claimant] suffered an injury as a result of deceptive practices touching its sale of securities . . . ."124 Whether the "touching" construction was intentional or, as many contend, merely a consequence of literary style, courts have since generally construed "in connection with" to suggest "some nexus but not necessarily a direct and close relationship"125 between the fraud and purchase or sale. Although the immediacy of that link remains unclear, it presumes, at a minimum, one very fundamental concept: the defrauded party is either a buyer, seller, or possesses a vested interest (e.g., a fiduciary or similar trusting relationship with the insider) in the transaction.126 That is, the Chiarella Court unequivocally stated that fraud and, in turn, "[nondisclosure] liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."127 Such a duty follows from "prior dealings" between buyers and sellers, and as such, there does not exist "a general duty between all participants in market transactions to forgo actions based on material, nonpublic information."128 Logically, therefore, "fraud" and "deceit" place limits on section 10(b)'s and Rule 10b-5's common "in connection with" language—for liability to arise, a duty to abstain or disclose must exist between parties to a transaction. Even Bankers Life & Casualty Co., with its de minimus touch test, embraced this principle, albeit
impliedly, for the fraud victim in that case was a seller of securities.129

Textual analysis of section 10(b) thus bears a two-pronged test for imposing insider trading liability. First, the alleged conduct must entail a material misrepresentation or omission in violation of one's duty to disclose nonpublic information. Second, where fraud is averred, the claimant must not only be a buyer, seller, or interested party to the securities transaction, but also one who, subsequent to establishing a direct relationship of trust and confidence with the respondent, sustains injury arising from a breach thereof. This dual inquiry demarks the outermost boundary of section 10(b)'s scope and, in doing so, provides a standard against which the misappropriation theory's validity may be measured.

B. The Misappropriation Theory: Caught Out of Bounds

Recall that, under the misappropriation theory, Rule 10b-5 is violated whenever one (1) "steals" material nonpublic information (2) via a breach of duty arising from a trusting or confidential relationship and (3) thereafter transacts upon that information, (4) regardless of whether he or she owed any duties to shareholders of the company in whose stock he or she trades.130 As such, "fraud" is manifested in the act of misappropriating information from another to whom a duty is owed. However, the "theory does not require that the buyer or seller of securities be defrauded."131 Rather, the section 10(b)—Rule 10b-5 "in connection with" requirement is deemed satisfied merely because the stolen information is later used in a securities transaction; the information's source need not be affiliated with either the buyer or seller.132

The misappropriation theory clearly does not meet the two-part test extracted from section 10(b)'s language. In contravention of the first prong, the theory imposes liability for any breach of fiduciary duty or similar trusting and confidential relationship, even where "deception" is non-existent. The theory also fails the test's second inquiry, for it does not require that the defrauded party be a buyer, seller, or one who

130. SEC v. Clark, 915 F.2d 439, 443 (9th Cir. 1990) (citing SEC v. Materia, 745 F.2d 197, 201-02 (2d Cir. 1984), cert. denied, 971 U.S. 1053 (1985)).
132. United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995). Because the "source" of the inside information is irrelevant for purposes of imposing § 10(b) liability under the misappropriation theory, it has been referred to as a "fraud—on—the—source" theory. See also Chestman, 947 F.2d at 567.
possesses an interest in the disputed transaction.

Although the Supreme Court majority in *Chiarella* did not entertain the misappropriation theory as a means by which to exact section 10(b) liability, the facts of that case nicely illustrate the theory's infirmities in practice. There, to reiterate, the defendant, Chiarella, misappropriated takeover bid information from his employer, Pandick Press, a financial printer, and with that knowledge traded in the securities of target companies. Chiarella owed, and admittedly breached, a duty to his employer. But Pandick was not a purchaser or seller of those target corporations' shares, nor did it possess an interest in Chiarella's transactions. Because the investing public was not personally defrauded, the misappropriation theory would have attempted to transpose Chiarella's defrauding of Pandick onto the market at large. However, the language of section 10(b) simply does not subscribe to such a tenuous nexus between the trader and marketplace.

Both *Bryan* and *O'Hagan* rejected the misappropriation theory on grounds similar to those articulated above. In each case, however, greater weight was accorded to the first prong of the aforementioned two-part inquiry. That is, section 10(b)'s and Rule 10b-5's common "in connection with" language was paid lip service, but somehow seemed secondary to the courts' "deception" analyses. This Comment submits that, while *Bryan* and *O'Hagan* were correctly decided, the "in connection with" requirement should have played a more significant role—one that rested on equal footing with section 10(b)'s "deception" constraint—in arriving at their respective conclusions. In other words, the "in connection with" language, on the one hand, and deception, on the other, are interrelated concepts that must be read together to gain definition. One can not deceive another unless one owes a duty to disclose to another. The "in connection with" requirement maintains the integrity of this duty-purchaser/seller relationship. The misappropriation theory, however, renders meaningless the "connection with" statutory language, as it permits liability for breaches of duty owed to individuals who are unconnected with and perhaps even uninterested in a securities transaction. An obvious question thus arises: Why would Congress

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134. *See supra* text accompanying notes 51-52.
135. *In Bryan*, for example, the Fourth Circuit limited its substantive analysis of § 10(b)'s "in connection with" requirement to a single footnoted paragraph. *See Bryan*, 58 F.3d at 950 n. 17.
have inserted empty words into one of the Exchange Act’s most significant, yet brief, provisions? Quite simply, it did not. The “in connection with” language should be understood for what it is, a legislative insurance policy against reading deception out of section 10(b). It is an integral part in the section 10(b) “package” and should not be tossed aside merely because Congress failed to include assembly instructions.

Whether this Comment accurately depicts the methodology which will eventually settle the misappropriation issue is subject to debate, but given the Supreme Court’s penchant for “plain meaning” interpretation and market deregulation, it is unlikely that the theory would endure judicial scrutiny upon a grant of certiorari. The Court’s strict adherence to statutory language simply poses too insurmountable an obstacle for individuals alleging new forms of liability under the 1934 Act. Assuming, then, that textualism ultimately brings an end to the misappropriation theory, how might the future regulation of insider trading be affected? Moreover, are there any policy considerations justifying the theory’s demise? Part V, in addressing these issues, recognizes that even though “plain meaning” analysis largely ignores concerns foreign to a statute’s text, no decision exists in a vacuum.

V. S.E.C. ENFORCEMENT OF THE 1934 ACT WITHOUT MISAPPROPRIATION AND POLICIES JUSTIFYING THE THEORY’S DEMISE

A. Insider Trading Regulation in the Absence of Misappropriation

Insider trading regulation is only as effective as the tools with which the S.E.C. has to work. For obvious reasons, therefore, that agency has vehemently opposed all efforts to quash the misappropriation theory. Similarly, market protectionist groups, including a large contingency of plaintiffs’ attorneys, maintain that the theory fills “a large gap” which “cannot be minimized.”137 Their concerns certainly are understandable, but nonetheless unwarranted, for a Supreme Court rejection of the misappropriation theory will ultimately have minimal impact on federal efforts to combat insider trading.138

Indeed, the necessity for misappropriation liability may be exaggerated. Chiarella and Dirks established an ambit of prohibited conduct within which the vast majority of section 10(b) offenses hitherto

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137. Jenkins, supra note 7, at 1331 (emphasis added).
prosecuted have fallen. More often than not, defendants are either traditional or constructive insiders and their tippees—individuals who would owe a duty to disclose material nonpublic information or abstain from trading even in the misappropriation theory's absence. In fact, the Second and Fourth Circuits have gone so far as to concede that past convictions premised on the theory might very well have been successful under the Chiarella-Dirks "classical" framework.

For example, in United States v. Newman, Jacques Courtois, Jr., and Adrian Antoniu, both employees of investment banking firms, misappropriated confidential information identifying the targets of proposed acquisitions undertaken by their respective employers' corporate clients. Courtois and Antoniu then surreptitiously conveyed this information to Mitchell Newman, who passed it on to Franklin Carniol and Constantine Spyropoulos. All three tippees traded in the stock of the target companies and shared their profits with Courtois and Antoniu. In two instances, the targets themselves were clients of Courtois' and Antoniu's investment banking firms. Although the Second Circuit found that Newman had violated section 10(b) and Rule 10b-5 under a misappropriation theory of liability, the classical theory would have sufficed. In other words, Courtois and Antoniu were "temporary insiders" of, and owed duties to, the two targets which their employers' firms represented. When they misappropriated information and passed their duties on to Newman, Courtois and Antoniu via Dirks' tippee principle, the subsequent trading activity constituted a clear "classical" theory violation. Much as courts have abused section 10(b) in finding meaning where none exists, the S.E.C. has unnecessarily exploited the misappropriation theory.

While misappropriation-free securities laws would not always reach those who trade on "stolen" information, the federal mail and wire fraud statutes provide adequate means by which to criminalize such

139. Id. at 952.
140. McLucas and Angotti, supra note 7, at 12.
141. See Chestman, 947 F.2d at 566 (noting that "[a] temporary insider theory of prosecution might well have covered the activities of the investment banker in Newman and the printer in Materia"): Bryan, 58 F.3d at 953 (citing Chestman, 947 F.2d at 566).
142. 664 F.2d 12, 15 (2d Cir. 1981).
143. Id.
144. Id.
145. Id. at n.1.
146. In this context, "stolen" information comprises information which has been misappropriated by an individual who owes no duty to the company in whose stock he or she subsequently trades.
activity.\textsuperscript{147} Actually, the Supreme Court's interpretation of sections 1341 and 1343, as espoused in \textit{United States v. Carpenter},\textsuperscript{148} may extend liability even beyond the misappropriation theory's purported scope. Whereas section 10(b) requires that the claimant be one who personally suffers from another's direct fiduciary breach, the plain language of the mail and wire fraud provisions mandate no such nexus between a misappropriator and his or her trading victim. Rather, sections 1341 and 1343 demand only that their respective mediums of communication "be used to execute the scheme at issue."\textsuperscript{149} This construction would seem to suggest that any person who obtains material

\textsuperscript{147} Bryan, 58 F.3d 933, 952 (1995). The federal mail and wire fraud laws consist of three separate statutes, 18 U.S.C. §§ 1341, 1343, and 1346. Section 1346, which provides the definition of "scheme of artifice to defraud" for application in sections 1341 and 1343, reads: "For the purposes of this chapter, the term 'scheme or artifice to defraud' includes a scheme or artifice to deprive another of the intangible right of honest services." 18 U.S.C. § 1346. The federal mail fraud statute, Section 1341 reads, in relevant part:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, or to sell, dispose of, loan, exchange, alter, give away, distribute, supply, or furnish or procure for unlawful use any \ldots security \ldots for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, or takes or receives therefrom, any such matter or thing, or knowingly causes to be delivered by mail or such carrier according to the direction thereon, or at the place at which it is directed to be delivered by the person to whom it is addressed, any such matter or thing, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.


The federal wire fraud statute, Section 1343, reads:

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice, shall be fined under this title or imprisoned not more than five years, or both. If the violation affects a financial institution, such person shall be fined not more than $1,000,000 or imprisoned not more than 30 years, or both.

18 U.S.C § 1343.


\textsuperscript{149} \textit{Id.} at 28.
nonpublic information via fraudulent means and thereafter trades upon it by use of the mails or wires will be subject to federal prosecution. And no one can reasonably deny that virtually every modern securities transaction is conducted via the mails and/or wires. Interestingly, Chief Justice Burger’s version of the misappropriation theory, articulated in his Chiarella dissenting opinion, is essentially of the same coverage as sections 1341 and 1343, but has fallen into disfavor among lower federal courts for being too expansive.

B. Policy Considerations Justifying the Misappropriation Theory’s Demise

Although textualism largely overlooks policy to extract meaning from a statute’s language, the Supreme Court accepts extra-textual considerations insofar as they may show a result “so bizarre” that Congress must have intended a different interpretation. This caveat to “plain meaning” analysis appears little more than a trivial judicial attempt at appeasing advocates of original intent and is, therefore, unlikely to be invoked in any decision rejecting the misappropriation theory. Nonetheless, there are sound policy justifications underlying the theory’s demise.

The misappropriation theory, with its foundations grounded in breaches of state-governed fiduciary relationships, simply does not provide clear guidelines by which investors may order their affairs, a problem whose obvious solution contradicts fundamental principles of federalism. As the Bryan court noted, the theory has imposed

150. See supra note 55.
151. These courts have generally followed Justice Stevens’s rendition of the misappropriation theory, articulated in his Chiarella concurrence. See, e.g., SEC v. Clark, 915 F.2d 439, 453 (9th Cir. 1990) (explaining that the theory “applies only where the misappropriation occurs by means of a violation of fiduciary or similar duty.”).
153. This Comment does not intend to diminish in importance the “so bizarre” exception to textual interpretation. However, due to the Supreme Court’s treatment of the caveat in past cases, it is evident that the threshold for finding a result beyond congressional intent has become virtually unattainable. For example, while the Central Bank Court proffered policy arguments to justify, rather than override, its textualist conclusion, it disposed of the “so bizarre” inquiry in a single sentence, stating simply: “That is not the case here.” Central Bank of Denver, 511 U.S. at 188.
155. Id. at 951.
liability arising from such diverse associations as between an employer and current employee, an employer and former employee, a newspaper and columnist, a psychiatrist and patient, a husband and wife, and a father and son. Whether a fiduciary or similar relationship of trust and confidence existed in each case depended on the law of the state in which the breach occurred. As such, the misappropriation theory, in effect, assumes fifty very different permutations, with some permitting certain trading practices where others prohibit them, and vice versa. Hence, to the extent that "it is essential . . . to have a guiding principle for those whose daily activities must be limited and instructed by the S.E.C.'s inside-trading rules," a rejection of the theory may also be predicated on non-textual bases. After all, the nature of centralized securities markets invariably requires interaction among individuals (i.e., security holders, brokers and traders) located in numerous states. Making the disposition of a federal Rule 10b-5 charge turn on a court's preliminary choice-of-law analysis is as daunting a proposition as recognizing fifty different variations of the same federal offense.

A federalized set of fiduciary relationships would undoubtedly obviate the shortcomings of a misappropriation theory reliant on state

157. See id.
162. For example, some states require a "valid corporate purpose" for the elimination of the minority interest through a short-form merger, whereas other states do not. Sante Fe Industries, Inc. v. Green, 430 U.S. 462, 479 n.16 (1977) (comparing Bryan v. Brock & Blevins Co., 490 F.2d 563 (5th Cir.), cert. denied, 419 U.S. 844 (1974) (merger arranged by controlling stockholder for no business purpose except to eliminate fifteen percent minority stockholder violated Georgia short-form merger statute), with Stauffer v. Standard Brands, Inc., 187 A.2d 78 (Del. Ch. 1962) (Delaware short-form merger statute allows majority stockholder to eliminate the minority interest without any corporate purpose and subject only to an appraisal remedy)). Thus, whereas the misappropriation theory would impose section 10(b) liability in Georgia for a majority shareholder's trades based on inside information that was obtained through an elimination of minority interests without any valid corporate purpose, it would not do so for the same act in Delaware (assuming the majority shareholder owed no duty to the individual with whom he or she transacted).
law principles. However, the Supreme Court has previously held that its recognition of such an approach would be both impracticable and tantamount to an usurpation of state authority:

Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.

When balancing the need to retain the misappropriation theory with that of protecting states' rights, both sound policy and common sense dictate that the latter consideration deserves greater accord. Indeed, financial markets will endure without the misappropriation theory, but the nation fueling them will fail without federalism. This obviously is not to say that all legal doctrines which promote federalism are necessarily desirable or ones threatening it are inherently repugnant. Rather, it is representative of the manner in which courts have over-exaggerated the breadth of section 10(b) liability and created liability for conduct that the 1934 Exchange Act never anticipated.

In light of numerous textual and policy justifications for the misappropriation theory's judicial rejection, one might reasonably wonder why its invalidity is even questioned. The answer is simple—Congress has never so much as defined "insider trading." Thus, virtually any interpretation may be read into section 10(b)'s vague language under the guise of that term. Given recent congressional concern for securities-related issues, it may very well be that the misappropriation theory's fate is ultimately decided on Capitol Hill.

VI. A PLEA FOR CONGRESS TO DEFINITIONALLY CODIFY "INSIDER TRADING"

Despite sixty years of judicial development, the law of insider trading remains unclear. Its evolution is replete with ad hoc decision-making and patchwork analysis. In all fairness, the Supreme Court has responded admirably to a barrage of illicit practices that the 1934 Act

164.  Id. at 951.
165.  Sante Fe Industries, 430 U.S. at 479 (citations omitted).
166.  LOSS & SELIGMAN, supra note 59, at 875.
never anticipated. However, as the incidences of insider trading continue to escalate,\textsuperscript{167} so too shall the confusion accompanying them. After all, there is no indication that unscrupulous investors will soon refrain from contriving innovative new methods of market exploitation. Hence, with recognition of the federal courts' already overburdened dockets, it is imperative that Congress intervene to define "insider trading."

Congress has twice flirted with codifying a comprehensive definition of "insider trading."\textsuperscript{168} Both the Insider Trading Sanction Act of 1984\textsuperscript{169} and Insider Trading and Securities Fraud Enforcement Act of 1988\textsuperscript{170} contemplated doing so, but neither altered the then existing substantive law.\textsuperscript{171} Congress was apparently satisfied with the judicial development of insider trading regulation and feared that flexibility would be lost if a bright-line rule were enacted.\textsuperscript{172} True, as the House Committee indicated, court-drawn parameters generally "have established clear guidelines for the vast majority of traditional insider trading cases."\textsuperscript{173} However, the same cannot be said for non-traditional (e.g., misappropriation) claims under section 10(b), for the misappropriation theory, in relying upon state fiduciary principles, effectively takes on fifty different forms, with some permitting certain trading practices where others prohibit them. Moreover, a legislative fix is not necessarily inconsistent with the S.E.C.'s ability to flexibly regulate insider trading, for Congress may, if it desires, define the term to cast upon a broad array of conduct. The issue is not one of scope, but specificity. As the law currently stands, investors simply are not provided with fair notice of those practices for which they may be penalized.\textsuperscript{174}

\textsuperscript{167.} See McLucas & Angotti, supra note 7 and accompanying text.
\textsuperscript{168.} LOSS & SELIGMAN, supra note 59, at 875.
\textsuperscript{171.} See LOSS & SELIGMAN, supra note 59 at 873 (citing H.R. Rep. No. 98-355, 98th Cong., 1st Sess. 13 (1983)).
\textsuperscript{173.} See LOSS & SELIGMAN, supra note 59, at 875 (citing H.R. REP. No. 100-910, at 12 (1988)).
\textsuperscript{174.} But the Supreme Court has decreed that the securities market "demands certainty and predictability," United States v. Bryan, 58 F.3d 933, 950 (4th Cir. 1995) (quoting Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 188 (1994) (citation omitted)), and that "it is essential . . . to have a guiding principle for those whose daily activities must be limited and instructed by the SEC's inside-trading rules." Bryan, 58 F.3d at 950 (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).
A. Formulating a Codified Definition of "Insider Trading"

Given the need for a legislative definition of insider trading, what form might it take? An examination of existing regulations governing foreign markets may provide the answer. For example, unlike the United States, the European Community (EC) has codified specific prohibitions to curtail insider trading.\textsuperscript{175} Council Directive 89/592: Coordinating Regulations on Insider Dealing (Directive), adopted among EC member nations in 1989, represents a departure from its American counterpart’s fraud rubric.\textsuperscript{176} Rather than focusing on breaches of fiduciary duty, as does section 10(b), the Directive succinctly defines "inside information,"\textsuperscript{177} "insiders,"\textsuperscript{178} and "insider trading."\textsuperscript{179} Although the struggle to establish competent agency implementation of this legislation has resulted in little discernable change,\textsuperscript{180} the European model is a lesson for our Congress. The EC Directive contemplates abuses that even section 10(b) cannot address, yet does so without sacrificing definitional clarity. Indeed, insider trading need not be a "term of art" to effectuate comprehensive regulation.

Domestic ingenuity has also contributed to the cause of defining


\textsuperscript{177} Under the Directive, "inside information" is that "information which has not been made public of a precise nature relating to one or several issuers of transferable securities or to one or several transferable securities, which, if it were made public, would be likely to have significant effect on the price of the securities in question." Council Directive 89/592, supra note 172, art. 1(2).

\textsuperscript{178} Article 2(1) of the Directive defines an "insider" as:

any person who: by virtue of his membership of the administrative, management or supervisory bodies of the issuer, by virtue of his holding in the capital of the issuer, or because he has access to such information by virtue of the exercise of his employment, profession, or duties, possesses inside information . . .

\textit{Id.} at 117-18.

\textsuperscript{179} The Directive contains separate provisions to define “insider trading” amongst primary violators (i.e., “tippers”) and secondary violators (i.e., “tippees”). Article 2(1) prohibits a primary insider “from taking advantage of [inside] information with full knowledge of the facts by acquiring or disposing of for his own account or for the account of a third party, either directly or indirectly, transferable securities of the issuer or issuers to which that information relates.” \textit{Id.} at 120. Article 4 effectively imposes “tippee” liability upon “any person other than those referred to in that Article who with full knowledge of the facts possess insider information, the direct or indirect source of which could not be other than a person referred to in article 2.” \textit{Id.} at 121.

\textsuperscript{180} See Standen, supra note 175, at 189.
“insider trading.” In 1985, the American Bar Association recommended alternative, fraud-free approaches to criminalizing illicit trading practices, but they proved too controversial for congressional approval. Two years later, the S.E.C. proposed its rendition of legislation which would have prohibited one’s..., buying or selling securities while in possession of material nonpublic information that was “wrongfully” obtained or the use of which would be wrongful. Information is wrongfully obtained or used if it is obtained by or as a result of, or if its use would constitute, (i) theft, bribery, misrepresentation, or espionage through electronic or other means, or (ii) a breach of duty to maintain information in confidence, when that duty arises from a relationship with specified sources ...

The language plainly was but a mere reiteration of then existing fiduciary and misappropriation theory principles. Thus, Congress purportedly had no incentive to codify that which already existed at common law. Clearly, however, its grounds for inaction were unjustified. The S.E.C.’s 1987 proposal was by no means conventional, for it sought to codify an insider trading theory that the Supreme Court had never approved, the Fourth and Eighth Circuits have since outrightly rejected, and legal commentators have continually questioned.

Past refusal to overhaul the securities laws and enact a definition of insider trading “does not necessarily indicate legislative unwillingness to consider narrower approaches.” That is, a solution may lie in supplementing, rather than supplanting, the Supreme Court’s interpretation of section 10(b) where lines of prohibited conduct are blurred. However, this option presupposes congressional disposition towards a broad definition of insider trading, one that would invariably entail codifying the misappropriation theory. Anything less will require sweeping reform, and will likely find its basis in the Chiarella-Dirks “classical” framework. Irrespective of the shape definitional legislation may take, be it “gap-filling” or revisionary, deceit and fraud should remain as its crux. After all, contemporary insider trading law is broken,
not irreparable, and its existing “classical” foundations effectively address relationships from which market violations typically arise. Of course, should Congress wish to codify the misappropriation theory, it need make but one simple revision to section 10(b)—replace the word “deceptive” with “fraudulent” in the statutory phrase, “[i]t shall be unlawful . . . [t]o use . . . any manipulative or deceptive device.”

B. Congressional Winds of Change Bring Promise for a Definitional Codification of “Insider Trading”

Perhaps the change in Congress’ political composition will coincide with an increased awareness of securities law issues. Relatively recent developments certainly would suggest so. On December 20, 1995, the House overrode President Clinton’s veto of a bill designed to curb private actions under section 10(b).\(^{185}\) Although the piece of legislation did not attempt to codify “insider trading,” it sends an encouraging message to those who have abandoned hope for congressional intervention on the issue.

Any definition of “insider trading” enacted under the current Republican-controlled House and Senate will undoubtedly differ from one that might have been passed by their Democratic predecessors.\(^{186}\) In contrast to the 1984 and 1988 legislative efforts at expanding the scope of insider trading law, the GOP’s infamous “Contract with America” conveys a general spirit of deregulation, not only in the securities context, but amongst many different areas of federal concern. Therefore, an expansion of the 1934 Act, and particularly section 10(b), is improbable in the years to come. Meanwhile, one can only remain optimistic about the prospect for a definitional codification of “insider trading.” Unfortunately, extraneous political influences\(^{187}\) and Washington bureaucracy shall continue to stymie future reform.

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187. For example, the bill discussed *supra* text and accompanying note 185, presented an “excruciating political dilemma for Mr. Clinton, dividing two of his key bases of political and financial support.” *Sands, supra* note 185, at A3. While one prominent plaintiffs’ attorney contributed $120,000 to the Democratic Party during the first six months of 1995, political action committees for the securities industry and “Big Six” accounting firms gave more than $150,000 in the same period to House reform supporters. *Id.*
VII. CONCLUSION

The day of which Justice Stevens spoke some seventeen years ago, to arrive later this year when the Supreme Court renders its decision in United States v. O'Hagan, shall mark a significant juncture in securities law jurisprudence. Whether that momentous day brings an end or a new beginning to the misappropriation theory is subject to speculation, but, as this Comment suggests, its judicial demise is more probable than not. Simply stated, the misappropriation theory is inconsistent with Dirks and Chiarella, as well as in conflict with the Court's time-honored textualist approach to interpreting section 10(b). The outcome would likely be no different if Congress, in its current deregulatory state, were to intervene and definitionally codify "insider trading." Irrespective of which governmental branch addresses the misappropriation theory's validity, it must be done with utmost sensitivity towards both investors' rights of fair notice and the S.E.C.'s ability to effectively, as well as efficiently, regulate securities markets.

Although highly-publicized insider trading scandals of the 1980's piqued Americans' interest in Wall Street and its underworld, the lackluster nature of more recent section 10(b) violations has largely stemmed their curiosity. Contemporary cases just "aren't quite as colorful ... we don't have a briefcase being exchanged in the hallway at midnight." If anything, the misappropriation theory's most endearing quality may be its potential to revive the drama of that foregone era. Without it, cases such as Carpenter would be reduced to the unglamorous world of mail and wire fraud. True, insider trading can entail tremendous intrigue and often raises societal outrage over dishonesty in the marketplace. However, is the anger really warranted? That is, perhaps the misappropriation issue is subsumed by a much larger question: Should insider trading be prohibited in the first place, and if so, why? While its answer requires more than a response of "Yes, because the practice is unfair," courts, commentators, and the S.E.C. alike have all had difficulty identifying what harms actually arise from trades based on material nonpublic information. To borrow from the words of Justice Stevens, "I think [this Comment] wisely leaves the resolution of this issue for another day." In the meantime, by enacting section 10(b),

188. Jenkins, supra note 7 at 1331 (quoting SEC Enforcement Director William McLucas).
Congress has drawn the lines in the war against insider trading. It is time that the courts and S.E.C. wage battle within them.

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