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## Mere Thieves

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## MERE THIEVES

ROBERT STEINBUCH\*

### I. INTRODUCTION

Today, criminals are capable of stealing financial secrets from multinational corporations.<sup>1</sup> These hackers can adversely affect stock markets by trading on stolen confidential information. Securities jurisprudence, however, has focused largely on the activities of insiders who secretly trade on information that they *legally* gain through their positions of trust—i.e., insider trading—and has not addressed the culpability of “mere thieves”<sup>2</sup> who trade on confidential financial information gained through *illegal* means.<sup>3</sup> As such, a void in securities law exists regarding how to address the theft and use of confidential financial information by strangers under the Securities and Exchange Commission’s (SEC) Rule 10b-5.<sup>4</sup>

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1. *See, e.g.*, Litigation Release No. 19,450, U.S. Securities and Exchange Commission, SEC Files Emergency Action Against Estonian Traders to Stop Ongoing Fraudulent Hacking Scheme (Nov. 1, 2005), <http://www.sec.gov/litigation/litreleases/lr19450.htm>; *see also* SEC v. Lohmus Haavel & Viisemann, No. 05-CV-9259 (S.D.N.Y. May 30, 2007) (final judgment against hackers).

2. David C. Bayne, *Insider Trading: The Misappropriation Theory Ignored: Ginsburg’s O’Hagan*, 53 U. MIAMI L. REV. 1, 64 (1998).

3. *See, e.g.*, *Chiarella v. United States*, 445 U.S. 222, 239–40 (1980) (Burger, C.J., dissenting) (arguing that insider trading rules should apply to “any person engaged in any fraudulent scheme,” not just parties with some fiduciary relationship); *see also* Bayne, *supra* note 2, at 64 (distinguishing “[m]ere” thieves from “[t]rusted” thieves); Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O’Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1255 (1998) (deeming it “doubtful” that a hacker’s or thief’s securities trades would violate Rule 10b-5); Rebecca S. Smith, Comment, *O’Hagan Revisited: Should a Fiduciary Duty Be Required Under the Misappropriation Theory?*, 22 GA. ST. U. L. REV. 1005, 1014 (2006) (describing the criticisms of *O’Hagan’s* fiduciary duty requirement, stating that the use of nonpublic information, not the manner in which it is acquired, is “at the heart” of the harm).

4. A stranger’s theft of confidential financial information may be a consequence of computer hacking or of more traditional misconduct such as burglary or robbery. But even if the theft is a consequence of computer hacking, many commentators believe that Section 10(b) and Rule 10b-5 probably do not cover misconduct by a “mere” thief.” *See, e.g.*, Nagy, *supra* note 3, at 1255. This is despite the SEC’s creation of an Internet enforcement division that investigates and prosecutes Internet securities-related fraud. *See* Internet Enforcement Program, <http://www.sec.gov/divisions/enforce/internetenforce.htm>

Recently, the SEC faced this issue in three cases where the defendants allegedly hacked into a financial institution's network and traded on the uncovered confidential information.<sup>5</sup> In the ensuing enforcement actions against the hackers, the SEC asserted that such behavior—mere thieves<sup>6</sup> trading on stolen confidential material—violates the SEC's well-known insider trading rule: 10b-5.<sup>7</sup> This Article engages the line of inquiry of whether Rule 10b-5 creates liability for securities trading by mere thieves.<sup>8</sup>

This Article will discuss the Securities and Exchange Act of 1934 (the Act), emphasizing the most prominent regulation promulgated by the SEC: Rule 10b-5 (the Rule).<sup>9</sup> Next, the Article will discuss the general fraud and insider trading bases for liability under Rule 10b-5.<sup>10</sup> This section will consider the two fundamental theories of insider trading liability: the classical theory,<sup>11</sup> and the misappropriation theory.<sup>12</sup> The Article will next analyze how mere thieves are liable under Rule 10b-5.<sup>13</sup> This section will particularly focus on recent SEC regulations extending liability under the misappropriation theory beyond the fiduciary sphere and the related case law. Finally, the Article will

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(last visited Apr. 4, 2008) (describing the SEC Office of Internet Enforcement and its mandates).

5. See generally Complaint, *SEC v. Lohmus Haavel & Viisemann*, No. 05-CV-9259 (S.D.N.Y. May 30, 2007) [hereinafter Complaint]; Plaintiff Securities and Exchange Commission's Response to Defendant Oliver Peek's Motion to Dismiss the Complaint and to Vacate Order of Preliminary Injunction, Freeze of Assets and Other Relief, *SEC v. Lohmus Haavel & Viisemann*, No. 05-CV-9259 (S.D.N.Y. May 30, 2007) [hereinafter Plaintiff's Response]; *SEC v. Blue Bottle Ltd.*, No. 07-CV-1380 (CSH) (S.D.N.Y. Feb. 26, 2007), *SEC v. Dorozhko*, 2008 WL 126612 (S.D.N.Y. Jan. 08, 2008).

6. The SEC did not employ this term in litigating *SEC v. Lohmus Haavel & Viisemann*. See generally Complaint, *supra* note 5.

7. Complaint, *supra* note 5, at 10–12; see also Plaintiff's Response, *supra* note 5, at 9–19 (arguing that trading by mere thieves violates Rule 10b-5). As this Article discusses below, insider trading jurisprudence is virtually all court created because Rule 10b-5 never mentions insider trading. See *infra* Part II.B.

8. This Article focuses primarily on Department of Justice and SEC enforcement actions. The analysis of this Article also applies to private causes of action, although those cases require plaintiffs to prove slightly different elements. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 754 (1975) (holding that private causes of action under Rule 10b-5 can be extended only to plaintiffs who are purchasers or sellers of securities, and who can therefore more easily establish that they were harmed by the use of information obtained in violation of Rule 10b-5).

9. See *infra* Part II.

10. See *infra* Part II.A–B. The latter source of liability is particularly important because it offers greatly enhanced penalties against defendants.

11. See *infra* Part II.B.1.

12. See *infra* Part II.B.2.

13. See *infra* Part III.

discuss regulatory and legislative options for resolving some of the confusion over the scope of Rule 10b-5.<sup>14</sup>

## II. THE SECURITIES AND EXCHANGE ACT OF 1934 AND SEC RULE 10b-5

The basic goals of the Securities and Exchange Act of 1934<sup>15</sup> are fairness and efficiency in securities transactions.<sup>16</sup> Section 10(b) of the Securities and Exchange Act of 1934 provides:

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

. . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.<sup>17</sup>

This section is considered to be a “catchall” provision aimed at fraud in securities trading.<sup>18</sup>

Pursuant to its authority under the Act, the SEC promulgated Rule 10b-5,<sup>19</sup> which is considered the primary SEC mechanism for regulating securities fraud, including insider trading.<sup>20</sup> The Rule states:

14. See *infra* Parts IV–V.

15. 15 U.S.C. §§ 78a–78u (2000).

16. See Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153 (1998). The authors stated that the purpose of the Act is to: provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preferences or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are open and orderly.

*Id.* at 175 n.97. See generally ELIZABETH SZOCKY, *THE LAW AND INSIDER TRADING: IN SEARCH OF A LEVEL PLAYING FIELD* (1993) (providing a comprehensive history of insider trading law); WILLIAM K.S. WANG & MARC I. STEINBERG, *INSIDER TRADING* § 2 (2d ed. 2006) (providing an in-depth discussion of insider trading).

17. 15 U.S.C. § 78j(b).

18. J. Dormer Stephen III, *United States v. O'Hagan: The Misappropriation Theory Under Section 10(b) and Rule 10b-5—Can the Judicial Oak Grow Any Higher?*, 102 DICK. L. REV. 277, 283 (1998).

19. 17 C.F.R. § 240.10b-5 (2007).

20. See *United States v. Lang*, 766 F. Supp. 389, 400 (D. Md. 1991) (affirming the SEC's authority to prosecute corporate insiders under Section 10(b) and Rule 10b-5 on the

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.<sup>21</sup>

Section 10(b) and Rule 10b-5 are “not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others.”<sup>22</sup> These broad remedial provisions are designed to address misleading or deceptive practices, regardless of whether they technically satisfy the common law (or statutory) requirements for fraud or deceit.<sup>23</sup> Judge Friendly of the United States Court of Appeals for the Second Circuit explained that the Act and Rule collectively protect investors by ensuring that purchasers of securities get what they expect and that sellers are not tricked into parting with their securities for a price the purchaser knows is inadequate.<sup>24</sup>

Courts recognize two general types of actionable fraud under the Rule and the Act. The first is the equivalent of common-law fraud liability, i.e., simple fraud, which prohibits misrepresentations.<sup>25</sup> The second is insider trading liability, which prohibits individuals from engaging in securities transactions with the benefit of certain information that they uniquely possess.<sup>26</sup> Rule 10b-5 makes no explicit mention of insider trading; the prohibition is purely judicial.<sup>27</sup>

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ground that Congress failed “to legislatively amend th[e] longstanding judicial acceptance of the use of Rule 10b-5” to prosecute insider trading).

21. 17 C.F.R. § 240.10b-5.

22. *Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961).

23. *Id.* at 910.

24. *Chem. Bank v. Arthur Anderson & Co.*, 726 F.2d 930, 943 (2d Cir. 1984).

25. *See Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 10 n.7 (1971) (citing *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)) (stating that all fraudulent schemes are prohibited by the Rule and the Act and not just those related to the purchase or sale of securities).

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

27. *See id.* (describing the judicial reasoning behind the insider trading prohibition); Szockyj, *supra* note 16, at 3 (“Neither the law nor the rule explicating it overtly prohibit

### A. *Simple Fraud*

The Supreme Court has held that "Rule 10b-5 prohibit[s] all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception."<sup>28</sup> Courts apply Rule 10b-5 to securities cases involving simple fraud.<sup>29</sup> Accordingly, those generally under no duty to disclose nonpublic information affecting the market price of securities on which they trade (i.e., outsiders) have been subject to Rule 10b-5 liability upon making affirmative misrepresentations related to such securities.<sup>30</sup>

For example, in the class action *Liebhard v. Square D Co.*, defendant Square D Company misrepresented the status of its takeover negotiations and, in doing so, detrimentally affected the interests of plaintiffs, some of whom traded options on the company's securities.<sup>31</sup> The Defendant corporation did not owe a fiduciary duty to these options traders, and had no duty to disclose to them takeover negotiations involving the company.<sup>32</sup> Nonetheless, the court denied the corporation's motion to dismiss, concluding that Rule 10b-5 imposes liability even absent a fiduciary relationship between a defendant and a victim of that defendant's affirmative misrepresentation.<sup>33</sup> In other words, simple fraud violates Rule 10b-5.

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insider trading."); see also *O'Hagan*, 521 U.S. at 652 (explaining how insider trading violates Rule 10b-5 through the application of the judicially created "classical" or "misappropriation" theories).

28. *Bankers Life*, 404 U.S. at 10 n.7 (citing *A.T. Brod & Co.*, 375 F.2d at 397).

29. See, e.g., *id.* at 10 (applying Rule 10b-5 to a fraudulent sale of securities that left a seller without compensation for the sale of its valuable securities).

30. See, e.g., *Deutschman v. Beneficial Corp.*, 841 F.2d 502, 506 (3d Cir. 1988) (concluding that nothing in the law of the Supreme Court "can be construed to require . . . a fiduciary relationship between a section 10(b) defendant and the victim of that defendant's affirmative misrepresentation"); *Fry v. UAL Corp.*, 895 F. Supp. 1018, 1032 (N.D. Ill. 1995) (discussing that Rule 10b-5 liability may attach despite a lack of fiduciary relationship in affirmative misrepresentation cases); *In re Gulf Oil/Cities Serv. Tender Offer Litig.*, 725 F. Supp. 712, 743-44 (S.D.N.Y. 1989) (holding that options purchased in reliance on affirmative misstatements may form the basis of a Rule 10b-5 violation); *Monetary Mgmt. Group v. Kidder, Peabody & Co.*, 615 F. Supp. 1217, 1222-23 (E.D. Mo. 1985) (holding that a broker who misrepresented the marginability of securities to a purchaser materially deceived the investor); see also *Basic Inc. v. Levinson*, 485 U.S. 224, 240 n.18 (1988) (asserting that there should not be a separate standard of materiality for securities fraud resulting from affirmative misrepresentations).

31. 811 F. Supp. 354, 354-55 (N.D. Ill. 1992).

32. *Id.* at 356.

33. *Id.* at 356-57; see also *In re Digital Equip. Corp. Sec. Litig.*, 601 F. Supp. 311, 315 (D. Mass. 1984) (ruling that Rule 10b-5 allows an optionholder "to sue for affirmative misrepresentations"); *Lloyd v. Indus. Bio-Test Lab., Inc.*, 454 F. Supp. 807, 811 (S.D.N.Y. 1978) (finding that a purchaser of calls has standing under Rule 10b-5 to sue for harm caused by affirmative misrepresentations).

### B. *Insider Trading*

While affirmative misrepresentations are actionable under Rule 10b-5 as simple fraud, courts have held that the Rule also prohibits insider trading.<sup>34</sup> Under Rule 10b-5, individuals may not purchase or sell securities based on knowledge of nonpublic information that they *legally* obtained or possessed as a consequence of their employment or similar circumstances.<sup>35</sup>

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34. See *SEC v. Monarch Funding Corp.*, 192 F.3d 295, 308 (2d Cir. 1999) (stating that Rule 10b-5 is violated by use of a fraudulent device, with scienter, in connection with the purchase or sale of securities); Plaintiff's Response, *supra* note 5, at 13-14 (arguing that the Rule prohibits insider trading).

35. *E.g.*, *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997); *Chiarella v. United States*, 445 U.S. 222, 226-30 (1980); see also *SEC v. Sulphur*, 401 F.2d 833, 851-52 (2d Cir. 1968) (en banc) (discussing liability based upon unequal access to knowledge). While informational disparities may be inevitable in the securities industry, liability arises to protect investors who would be less likely to put their money at risk if "trading based on misappropriated nonpublic information [wa]s unchecked by law," *O'Hagan*, 521 U.S. at 658, and to protect corporations that would incur increased risk of loss on their investments if information was prematurely disclosed, *United States v. Chestman*, 947 F.2d 551, 577 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part), *cert. denied*, 503 U.S. 1004 (1992).

The SEC proposed, and the courts over some time established, liability under 10b-5 for people who trade on material nonpublic information acquired through holding a position of trust, that is, insider trading. *E.g.*, *O'Hagan*, 521 U.S. at 652-53; *Chiarella*, 445 U.S. at 226-30. Courts recognize and protect the inside information as a property interest. See *Carpenter v. United States*, 484 U.S. 19, 25-26 (1987) ("Both courts below expressly referred to the [Wall Street] Journal's interest in the confidentiality of the contents and timing of the 'Heard' column as a property right, and we agree with that conclusion. Confidential business information has long been recognized as property.") (citation omitted). *But cf.* Roberta S. Karmel, *The Relationship Between Mandatory Disclosure and Prohibitions Against Insider Trading: Why a Property Rights Theory of Inside Information Is Untenable*, 59 BROOK. L. REV. 149, 168-73 (1994) [hereinafter Karmel, *Why a Property Rights Theory of Inside Information is Untenable*] (arguing that the property rights theory should not apply to inside information).

The 1985 Task Force on Regulation of Insider Trading expanded on the concept of fairness underlying the application of Rule 10b-5 to insider trading in its report:

[C]ommonsense observations suggest that two of the traditional bases for prohibitions against insider trading are still sound: the "fair play" and "integrity of the markets" arguments. The first relies on the basic policy that cheating is wrong and on the traditional sympathy for the victim of the cheat. The second rests on the oft-repeated argument that people will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed.

SzOCKYJ, *supra* note 16, at 2. While the trading of a single corporate insider may not seem like a very threatening prospect, it has the potential to be magnified as others piggyback off the insider's repeated successful trading. *Chestman*, 947 F.2d at 577-78 (Winter, J., concurring in part and dissenting in part). Eventually, some may begin to guess the reason behind the trading, the corporate secret, increasing the risk that the confidential information will be widely disclosed, and the true owner of the information will lose its investment entirely. *Id.* The existence of this "word of mouth" circulation of material, nonpublic information is demonstrated in stories put out by the media. Theodore C. McCullough,

Neither the Act nor the Rule expressly addresses insider trading. Rather, the Rule prohibits fraud in connection with the purchase or sale of a security.<sup>36</sup> The issue in establishing insider trading liability under 10b-5, therefore, was whether regulators and courts could characterize insider trading as fraud or deceit.<sup>37</sup> The courts, with the SEC's endorsement, addressed this concern by equating a breach of fiduciary or fiduciary-like duty with the fraud requirement of 10b-5.<sup>38</sup> Thus, if an insider intends to trade securities based on confidential information gained through a fiduciary relationship with the information's owner, the insider commits fraud by failing to disclose his trading intentions to the information's owner prior to the trade.<sup>39</sup> Using this linguistic legerdemain of equating the *failure to disclose trading intentions* with *fraud*,<sup>40</sup> the courts created insider trading liability under Rule 10b-5 and proceeded to expand the Rule's scope.<sup>41</sup>

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Note, *United States v. O'Hagan: Defining the Limits of Fraud and Deceptive Pretext Under Rule 10b-5*, 22 SEATTLE U. L. REV. 311, 327 (1998). Additionally, this type of dissemination is even more frustrating for corporations and investors because few who participate in this type of activity are caught. *Id.* at 328–29.

36. 17 C.F.R. § 240.10b-5 (2007); see *Makor Issues and Rights, Ltd. v. Tellabs*, 437 F.3d 588, 595 (7th Cir. 2006) (articulating the rule that a plaintiff can obtain damages under Rule 10b-5 if he or she is able to prove that: "(1) the defendant made a false statement or omission (2) of material fact (3) with scienter (4) in connection with the purchase or sale of securities (5) upon which the plaintiff justifiably relied and (6) that the false statement proximately caused the plaintiff damages").

37. See *Cady, Roberts & Co.*, 40 S.E.C. 907, 911–12 (1961) (discussing the basis for finding liability for insider trading within the confines of Rule 10b-5).

38. See, e.g., *SEC v. Rocklage*, 470 F.3d 1, 6 (1st Cir. 2006) (discussing the theories of insider trading liability under Rule 10b-5); WANG & STEINBERG, *supra* note 16, § 5:1 (same).

39. *Rocklage*, 470 F.3d at 6.

40. Cf. Transcript, *Roundtable on Insider Trading: Law, Policy, and Theory after O'Hagan*, 20 CARDOZO L. REV. 7, 27 (1998) [hereinafter *Roundtable on Insider Trading*] (Ralph K. Winter, Judge, United States Court of Appeals for the Second Circuit) (stating that a breach of fiduciary duty "has nothing to do with fraud or any traditional concept of fraud").

41. Commentators disagree on whether insider trading laws positively or negatively affect the efficiency of the market. For in-depth discussions on the economic efficiency of permitting or restricting the use of market information, see John F. Barry III, *The Economics of Outside Information and Rule 10b-5*, 129 U. PENN. L. REV. 1307, 1315–19 (1981), and Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 110–11 (1998) [hereinafter Karmel, *Outsider Trading*]. While some argue that permitting insider trading increases efficiency because it allows the market to more quickly reflect relevant information, others assert that it is inefficient because it subjects the market to manipulation and discourages research and analysis while encouraging theft. Compare Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 354–55 (1988) (criticizing traditional economic reasons for imposing liability on insider trading), with Nagy, *supra* note 3, at 1294 (arguing that insider trading creates inefficiencies in the market). One commentator has focused specifically on the efficiency problems caused by insider trading:

The courts have developed two general theories to guide the application of their judicially created insider trading jurisprudence,<sup>42</sup> as

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A privilege to exploit information improperly obtained would reduce the incentive to invest in legitimate information production by exacerbating free rider problems and by placing on producers the risk of misappropriation. Less information would be produced, because at least some producers would shift resources from additional production to theft of what others had produced.

Barry, *supra*, at 1364. Indeed, even if one admits that permitting insider trading promotes efficient allocation of information, any of the presumed benefits are negligible compared to the harm it has the potential to cause. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 629-32 (1984) (stating that because derivatively informed trading is slow to permeate the market and does not always occur, it does not have a significant impact on efficiency). In contrast, the idea that insider trading makes the market more efficient is typically grounded on the efficient market hypothesis, which relies on increasing the distribution of information (whether public or not) to the market. Cox & Fogarty, *supra*, at 355; Karmel, *Outsider Trading*, *supra*, at 110 n.160. Commentators have written extensively on the efficient market hypothesis (in all of its variations). For an in-depth discussion of the efficient market hypothesis, see Barry, *supra*, at 1330-59. Incidentally, the property rights theory discussed above appeals more to those who focus on principles of efficiency in relation to securities regulation rather than those who focus on fairness. Karmel, *Outsider Trading*, *supra*, at 112. There is also a middle ground that would apply the rules of intellectual property to inside information. See Karmel, *Why a Property Rights Theory of Inside Information is Untenable*, *supra* note 35, at 150-51 (citing BERNHARD BERGMANS, INSIDE INFORMATION AND SECURITIES TRADING—A LEGAL AND ECONOMIC ANALYSIS OF LIABILITY IN THE USA AND EUROPEAN COMMUNITY 106, 118-19 (1991); JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS AND POLICY 45-47 (1991)).

42. *United States v. O'Hagan*, 521 U.S. 642, 652 (1997). At first glance, the history of Rule 10b-5 seems haphazard, and with good reason: the decision to create the Rule was as much a product of the times as the development of its application has been. Milton Freeman told the story of the birth of the Rule as follows:

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 this 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 Summer Pike who said, "Well," he said, "we are against fraud, aren't we?" That is how it happened.

Stephen, *supra* note 18, at 284 n.32 (quoting Milton Freeman, *Remarks Before the Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967)).

well as the public's perception of it:<sup>43</sup> the classical theory and the misappropriation theory.<sup>44</sup> Each of these theories of liability is analyzed *in seriatim*.

### 1. *The Classical Theory*

Under the classical theory of insider trading liability, a person violates Rule 10b-5 by trading on material, nonpublic information because the trade breaches a duty (nominally) owed to the person with whom the insider trades, i.e., the former or future shareholder of the corporation whose stock is the subject of the trade.<sup>45</sup> That duty is founded on an employment or other fiduciary relationship that the insider has with the shareholders of the company whose stock is traded.<sup>46</sup> This theory was first formally recognized by the majority opinion in *Chiarella v. United States*.<sup>47</sup>

While the explicit language of the classical theory rests on an alleged fiduciary relationship between employees, or the like, of a corporation and its shareholders, this description (like much in insider trading jurisprudence) is imprecise. Employees and similarly situated

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43. See Bhavik R. Patel, *Rule 10b-5 No Longer Scares the Judiciary, but May Scare Corporate Defendants: The United States Supreme Court Switches Directions*, 25 U. ARK. LITTLE ROCK L. REV. 191, 200 (2002) (noting that the broad language of Section 10(b) and Rule 10b-5 could misinform public opinion and lead to frivolous litigation).

44. See, e.g., *United States v. Chestman*, 947 F.2d 551, 564 (2d Cir. 1991) (acknowledging the two recognized Rule 10b-5 fraud theories). The Supreme Court in *United States v. O'Hagan* distinguished the two theories as follows:

Under [the misappropriation] theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.

The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities. The classical theory targets a corporate insider's breach of duty to shareholders with whom the insider transacts; the misappropriation theory outlaws trading on the basis of nonpublic information by a corporate "outsider" in breach of a duty owed not to a trading party, but to the source of the information.  
521 U.S. at 652-53.

45. *O'Hagan*, 521 U.S. at 651-52. The shareholder typically is either a *former* shareholder, if the insider buys securities, or a *future* shareholder, if the insider sells securities. This oversimplifies reality for the purpose of explication, because the shareholder may choose to sell only a portion of his ownership position or may buy additional shares in a corporation in which he already has an ownership position.

46. 445 U.S. 222, 227-28 (1980).

47. A.C. Pritchard, *United States v. O'Hagan: Agency Law and Justice Powell's Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 15 (1998).

individuals actually owe fiduciary duties to their employers,<sup>48</sup> not to the shareholders of those corporations.<sup>49</sup> Moreover, even assuming, *arguendo*, the relationship between a corporation's employees and its shareholders could be characterized as fiduciary, the *Chiarella* Court admitted that the shareholders to whom the insider owes this alleged fiduciary duty need not even own shares until *after* the completion of the insider trading transaction.<sup>50</sup> As such, the relationship creating the insider trading liability cannot be accurately characterized as the alleged fiduciary duty owed by employees to shareholders, because the breach of the fiduciary duty would *precede* the creation of the fiduciary relationship. More accurately, this theory recognizes that liability derives from a fiduciary obligation that an insider owes the issuer of the security traded, that is, the obligation of an employee to his employer.<sup>51</sup> Regardless of the theory's true foundation, the classical theory (as the name suggests), narrowly defines insider trading.

The facts of *Chiarella* help explain the classical theory. In this case, Chiarella, the markup man for a financial printer, obtained confidential information about a corporate takeover by decoding the material given to his employer.<sup>52</sup> Chiarella used the information to purchase stock in the target company with which he had no employment or other fiduciary connection.<sup>53</sup> After the takeover was announced, Chiarella then sold the stock at a profit.<sup>54</sup> The government

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48. See RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006) ("An agent has a fiduciary duty to act loyally for the principal's benefit in all matters connected with the agency relationship."); see, e.g., *Veco Corp. v. Babcock*, 611 N.E.2d 1054, 1059 (Ill. App. Ct. 1993) (stating that corporate officers "owe a fiduciary duty of loyalty to their corporate employer not to (1) actively exploit their positions within the corporation for their own personal benefit, or (2) hinder the ability of a corporation to continue the business for which it was developed") (citations omitted).

49. Eric W. Orts, *Shirking and Sharking: A Legal Theory of the Firm*, 16 YALE L. & POL'Y REV. 265, 310 (1998) ("Although board members 'resemble agents in that they act on behalf of others and are fiduciaries owing duties of loyalty and care,' they owe these duties 'to the corporation itself rather than to the shareholders individually or collectively.'") (quoting RESTATEMENT (SECOND) OF AGENCY § 14C cmt. a (1958)).

50. *Chiarella*, 445 U.S. at 227 n.8 (citing *Cady, Roberts & Co.*, 40 S.E.C. 907, 913 n.21, 914 n.23 (1961)).

51. Throughout this Article, for simplicity's sake, I will refer to the relationship giving rise to classical liability for insider trading as between either the employee and the corporation or the employee and the shareholders—recognizing that the explanation above provides more detail on this issue.

52. *Chiarella*, 445 U.S. at 224.

53. *Id.* at 224, 232–33. By definition, Chiarella purchased the stock from shareholders of the target company—persons with whom he had no connection. *Id.* at 232–33.

54. *Id.* at 224.

investigated, indicted, and convicted Chiarella on seventeen counts of violating Section 10(b) and Rule 10b-5.<sup>55</sup>

The Supreme Court reversed Chiarella's conviction because, according to the Court, he had no duty to disclose his intention to trade or to abstain from trading on the confidential information because he was neither an explicit insider (employee) nor a fiduciary or quasi-insider (such as an accountant or a lawyer), and did not have any fiduciary relationship with those with whom he traded.<sup>56</sup> Under common law rules, silence constitutes fraud only if the defendant has a duty to disclose, a duty that typically flows from a fiduciary relationship.<sup>57</sup> The Court stated that the Act "cannot be read 'more broadly than its language . . . permit[s]'" and that although Section 10(b) serves as a catchall provision, "what it catches must be fraud."<sup>58</sup> The Court, therefore, rejected the broader "parity-of-information" theory, a theory that creates liability when any person trades on information not generally available on the market without first disclosing that information to the public.<sup>59</sup> The Court refused to consider whether Chiarella's conviction could have been affirmed based on a duty he owed to his employer (the financial printer) to keep the information

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55. *Id.* at 225.

56. *Id.* at 232-33, 235. The Court held that a duty to disclose arises only "when one party has information 'that [another] is entitled to know because of a fiduciary or other similar relation'" between the two. *Id.* at 228 (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)). Therefore, a person who is neither an insider nor a fiduciary has no obligation to disclose such information to anyone. *Id.* at 229. In fact, the Court noted that Chiarella was not an agent, fiduciary, or a person in which the sellers had placed their trust; instead, he was "a complete stranger who dealt with the sellers only through impersonal market transactions." *Id.* at 232-33.

57. See *Sw. E & T Suppliers, Inc. v. Am. Enka Corp.*, 463 F.2d 1165, 1166 (5th Cir. 1972) ("Texas law is clear that if there is no confidential or fiduciary relation between the parties [creating a duty to disclose], mere silence does not amount to fraud or misrepresentation."); *Cole v. Hartford Accident & Indem. Co.*, 46 N.W.2d 811, 817 (Iowa 1951) ("[S]ilence of a defendant does not amount to fraudulent concealment . . . unless a fiduciary relation exists between plaintiff and defendant, imposing upon the latter the duty to reveal to the former all facts which might affect his interest."); *Friedman v. Jablonski*, 358 N.E.2d 994, 997 n.3 (Mass. 1976) (stating that silence constitutes fraudulent concealment only in a fiduciary relationship); *Toombs v. Daniels*, 361 N.W.2d 801, 809 (Minn. 1985) (stating that silence may amount to fraud where a fiduciary relationship exists).

58. *Chiarella*, 445 U.S. at 234-35 (quoting *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979)). The Court stated that not every instance of financial unfairness constitutes fraudulent activity under Section 10(b). *Id.* at 232.

59. *Id.* at 233-35. The Court noted that neither the language nor the legislative history indicated that Section 10(b) was intended to recognize a general duty between all market participants to abstain or disclose. *Id.* at 233. This, however, was the only theory expressly rejected by the *Chiarella* Court. As will be seen later, this left the door open for application of the misappropriation theory, as well as other possible interpretations. See *infra* Part II.B.2.

confidential because that theory—the “misappropriation theory”—was not submitted to the jury.<sup>60</sup>

Thus, *Chiarella* could be read to confine insider trading liability to insiders and quasi-insiders. But the Court side-stepped the issue of whether the breach of other relationships of trust could give rise to insider trading violations by refusing to consider the issue for procedural reasons.<sup>61</sup> Accordingly, under the classical theory, current employees who trade on inside information are covered by Rule 10b-5 because they owe a direct duty to their employer not to trade on material, nonpublic information about their employer gained by virtue of their employment.<sup>62</sup>

The classical theory quickly expanded. In *SEC v. Cherif*,<sup>63</sup> the Seventh Circuit held that a former employee owes a common law duty to his former employer “to protect any confidential information entrusted to him by his employer during his employment.”<sup>64</sup> The court, therefore, held that a former employee resembles a current employee in his insider status, and, as such, “is obligated to continue to protect such information after his termination.”<sup>65</sup>

The Supreme Court further broadened its *Chiarella* holding in *Dirks v. SEC* by extending liability to “tippees”—those who receive material, nonpublic information from persons who have a duty to disclose or abstain from trading.<sup>66</sup> *Dirks*, a securities analyst, was told by a former officer of a company that the company engaged in fraudu-

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60. *Id.* at 235–36. In response to the *Chiarella* decision, the SEC immediately promulgated Rule 14e-3, which prohibits anyone from trading on material, nonpublic information about a tender offer without requiring that any particular relationship exist between the trader and the source of the information. Painter et al., *supra* note 16, at 167. Under this rule, “[t]he relationship between the trader and the source of the information is irrelevant . . . .” *Id.* The Supreme Court has held that Rule 14e-3 is within the SEC’s rulemaking authority. *United States v. O’Hagan*, 521 U.S. 642, 676 (1997) (“[I]nsofar as it serves to prevent the type of misappropriation charged against O’Hagan, Rule 14e-3(a) is a proper exercise of the Commission’s prophylactic power under § 14(e).”).

61. *See Chiarella*, 445 U.S. at 235–36.

62. *See id.* at 226–28.

63. 933 F.2d 403 (7th Cir. 1991). In this case, Danny Cherif falsified a memo stating that his identification card should remain active after his termination because he would be working part time on a special project, and he used this card to enter his former employer’s building after normal business hours for a year after his termination. *Id.* at 406. During this time, Cherif obtained confidential information about transactions and targets and used it to trade in the stocks of certain companies. *Id.*

64. *Id.* at 411.

65. *Id.*

66. 463 U.S. 646, 659–60 (1983). *Dirks* also provided that temporary insiders, such as accountants or attorneys, can potentially be liable not only as tippees, but as tippers under the classical theory. *Id.* at 655 n.14.

lent activity.<sup>67</sup> During his attempts to verify this information, Dirks told others, and some of the tippees traded based on that information.<sup>68</sup> The Supreme Court articulated that tippees could be held liable just like traditional insiders.<sup>69</sup> The Court reversed Dirks's conviction, however, because the person who tipped him off did not breach a fiduciary duty to the company.<sup>70</sup> The Court further stated that tippees do not breach a fiduciary duty if they did not receive any personal gain from revealing the information.<sup>71</sup> The Court recognized the innocent motives of Dirks and his tipper, and, therefore, found them not liable.<sup>72</sup>

The *Dirks* Court limited the expansion of Rule 10b-5 liability to tippees, continuing to require that the tipper in this context breach a direct fiduciary obligation to the company whose confidential information was the basis for the trade before imposing liability on the tipper or the tippee.<sup>73</sup> This maintained the classical theory's insistence on a fiduciary or fiduciary-like relationship between the company whose security was traded and the insider trader, although the relationship was far more tenuous than the one described in *Chiarella*.<sup>74</sup>

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67. *Id.* at 648–49.

68. *Id.* at 649. Because he played a critical role in exposing a massive fraud, the SEC only censured Dirks. *Id.* at 651–52.

69. *Id.* at 660–61. The Court said:

Thus, some tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them *improperly*. And for Rule 10b-5 purposes, the insider's disclosure is improper only where it would violate his *Cady, Roberts* duty. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.

*Id.* (citations omitted).

70. *Id.* at 666–67.

71. *Id.* at 662. In response, Justice Blackmun argued in his dissent that “[t]he fact that the insider himself does not benefit from the breach does not eradicate the shareholder's injury. . . . Personal gain is not an element of the breach of this duty.” *Id.* at 673–74 (Blackmun, J., dissenting). Justice Blackmun also argued that Dirks's actions should be considered a violation; otherwise, the result would be “a disservice to this country's attempt to provide fair and efficient capital markets.” *Id.* at 679.

72. *Id.* at 666–67 (majority opinion). This element of the *Dirks* tipper-tippee liability test, however, seems driven—like much of insider trading jurisprudence—by the specific facts of the case.

73. *Id.* at 660–61.

74. See *United States v. Chestman*, 947 F.2d 551, 565 (2d Cir. 1991) (delineating the expansion of the fiduciary duty concept from *Chiarella* to *Dirks*).

## 2. *The Misappropriation Theory*

The concurring and dissenting opinions in *Chiarella* demonstrated support by several members of the Court for the broader “misappropriation theory.” Under this theory, insider trading prohibitions are extended to outsiders, or persons unaffiliated with the corporation whose shares are traded.<sup>75</sup> Indeed, in their minority opinions, Chief Justice Burger<sup>76</sup> and Associate Justices Brennan,<sup>77</sup> Blackmun,<sup>78</sup> and Marshall<sup>79</sup> all agreed that a violation of Section 10(b) occurs whenever a person “improperly obtains” and uses material, nonpublic information “in connection with the purchase or sale of securities.”<sup>80</sup>

The Chief Justice’s dissent in *Chiarella* supported the idea of an absolute duty to disclose or abstain from trading if a person acquired material, nonpublic information illegally, regardless of the source:

By their terms, these provisions reach *any* person engaged in *any* fraudulent scheme. . . . 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.”<sup>81</sup>

The Chief Justice stated that his interpretation of the Rule was “in no sense novel” because it followed logically from the *In re Cady, Roberts & Co.*<sup>82</sup> administrative decision that first stated the disclose or abstain

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75. *Roundtable on Insider Trading*, *supra* note 40, at 10 (Professor Lawrence A. Cunningham, Benjamin N. Carodozo School of Law).

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

77. *Id.* at 239 (Brennan, J., concurring). Justice Brennan stated that he agreed with the Chief Justice’s view of the substantive law, but he concurred in the judgment because he believed the misappropriation theory was not presented to the jury in this case. *Id.* at 239.

78. *Id.* at 246 (Blackmun, J., dissenting). Justice Blackmun criticized the majority by stating that “[t]he Court continues to pursue a course, charted in certain recent decisions, designed to transform § 10(b) from an intentionally elastic ‘catchall’ provision to one that catches relatively little of the misbehavior that all too often makes investment in securities a needlessly risky business for the uninitiated investor.” *Id.*

79. *Id.* at 246. Justice Marshall joined in Justice Blackmun’s dissent. *Id.* at 245.

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

81. *Chiarella*, 445 U.S. at 240–41 (Burger, C.J., dissenting) (quoting *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972)). The Chief Justice’s dissent outlined a broad, “‘fraud on investors’ misappropriation theory.” Nagy, *supra* note 3, at 1235. The “fraud on investors” approach was somewhat successful in *United States v. Newman*, 664 F.2d 12, 16 (2d Cir. 1981), in which the court held that the defendants had violated Rule 10b-5 despite the fact that their sources for the information were neither their employers nor purchasers or sellers of a target company.

82. 40 S.E.C. 907 (1961). In *Cady, Roberts*, a broker-dealer was found guilty of violating Rule 10b-5 because he sold a large amount of company stock shortly after finding out about the company’s decision to reduce dividends. *Id.* at 909, 911. He acquired this infor-

rule for corporate insiders.<sup>83</sup> He asserted that the informational advantage gained by obtaining material information through unlawful means demands consideration of the same factors the SEC considered in *Cady, Roberts* to determine whether one has a duty to disclose: (1) whether one had access to information that was intended only for a corporate purpose and not a personal benefit; and (2) the inherent unfairness in trading based on information unavailable to others involved in the transaction.<sup>84</sup> The SEC has long argued that the misappropriation theory extends beyond direct business relationships,<sup>85</sup> and has stated that insiders such as officers, directors, and controlling stockholders “do not exhaust the classes of persons upon whom there is . . . an obligation” to “disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment.”<sup>86</sup> Thus, according to Chief Justice Burger, when someone has obtained inside information and wants to exploit it, that person must either disclose the information or abstain from trading in order to avoid liability under the Rule.<sup>87</sup>

Justice Blackmun echoed this sentiment in his *Chiarella* dissent, stating that “[t]he Court has observed that the securities laws were not intended to replicate the law of fiduciary relations. Rather, their purpose is to ensure the fair and honest functioning of impersonal national securities markets where common law protections have proved inadequate.”<sup>88</sup> The minority, therefore, offered support for an in-

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mation from a director of the company before the information had been publicly disclosed. *Id.* at 909.

83. *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting). The Chief Justice maintained that the majority opinion left open the question of the misappropriation theory’s validity because it concluded that the question was not presented to the jury. *Id.* at 243. Thus, according to the Chief Justice, the Court’s actual holding was much narrower than its discussion in the opinion indicated. *Id.* at 243 n.4.

84. *Id.* at 241–42.

85. See, e.g., Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,729–30 (Aug. 24, 2000) (codified at 17 C.F.R. § 240.10b5-2 (2007)) (specifying those relationships in which a duty of trust or confidence automatically exists under the misappropriation theory of insider trading); 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG AND LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD § 6:489 (2d ed. 2007) (“Rule 10b5-2 rejects the reasoning of *Reed* and *Chestman* [holding that a fiduciary business relationship is required] and essentially turns the SEC positions [supporting nonbusiness-related liability in those cases] into law.”). Rule 10b5-2 was specifically intended *not* to apply to business relationships. *SEC v. Talbot*, 430 F. Supp. 2d 1029, 1061 n.91 (C.D. Cal. 2006).

86. *Cady, Roberts & Co.*, 40 S.E.C. at 911, 912. The SEC stated that it was “not to be circumscribed by fine distinctions and rigid classification.” *Id.* at 912.

87. *Chiarella*, 445 U.S. at 240–42 (Burger, C.J., dissenting).

88. *Id.* at 248 (Blackmun, J., dissenting) (citations omitted).

sider trading theory essentially based on parity of *access* to material information.<sup>89</sup>

Seven years after *Chiarella*, the Court evenly divided<sup>90</sup> over whether to apply the misappropriation theory to a columnist who used information from his not-yet-published column to trade securities featured in his column.<sup>91</sup> In *Carpenter v. United States*,<sup>92</sup> four Justices held that the defendant-columnist owed a duty to his employer, the source and owner of the information on which he traded, and further stated that the columnist's actions satisfied the "in connection with" requirement even though the victim of the fraud, the employer-newspaper, was not a purchaser or seller of securities.<sup>93</sup> In so doing, the Justices asserted that "[t]he Journal had a property right in keeping confidential and making exclusive use, prior to publication, of the

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89. *Id.* at 252 n.2. The parity of access theory is premised on the idea of "investor expectations regarding the relative accessibility of corporate information to market participants." Painter et al., *supra* note 16, at 163 n.39. Another commentator remarked that

[i]n *Texas Gulf Sulfur*, the SEC argued, and the United States Court of Appeals for the Second Circuit accepted, the theory that the antifraud provisions of the Exchange Act require a parity of information among all traders in the public securities markets. This did not mean that all investors should have precisely the same information; rather, they should all enjoy access to the same information. . . . [The] parity of information theory was eventually rejected.

Karmel, *Outsider Trading*, *supra* note 41, at 89.

90. *Carpenter v. United States*, 484 U.S. 19, 24 (1987). The Court was split 4-4 because Justice Kennedy had not yet filled the seat vacated by Justice Powell. Nagy, *supra* note 3, at 1238 n.70. If Justice Powell had still been on the Court, the misappropriation theory likely would have suffered defeat, as Justice Powell had influenced the decision to grant certiorari because he wanted the opportunity to deny the validity of the theory. *Id.* Interestingly, one commentator has stated that with Justice Powell's retirement, the Court lost the only member who could be labeled a "corporate lawyer," and thus, the Court since then has been criticized for the lack of logic, clarity, and usefulness of its securities law decisions. Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History*, *Central Bank's Future*, 20 DEL. J. CORP. L. 865, 868 (1995).

91. In this case, R. Foster Winans co-authored the "Heard on the Street" column for the *Wall Street Journal*, which discussed stocks and provided opinions about the investment potential of each stock. *Carpenter*, 484 U.S. at 22. Because the column had an excellent reputation, it could affect the price of the stocks it discussed. *Id.* The *Wall Street Journal's* policy was that the column's content was confidential information until publication; however, Winans entered into a scheme by which he would inform others of the contents of the column before publication so that they could trade based on the potential effect the column would have on the market, and the group would share any profits obtained via this scheme. *Id.* at 23. The district court found that Winans had misappropriated confidential information and was guilty of a Rule 10b-5 violation, and the court of appeals affirmed. *Id.* at 23-24.

92. *Id.* at 19.

93. *Id.* at 24.

schedule and contents of the . . . column.”<sup>94</sup> But the Justices could not find a fifth vote.<sup>95</sup>

In the meantime, several federal appellate courts, including the Second, Third, Seventh, and Ninth Circuits, “adopted the misappropriation theory and applied it in a variety of fact patterns involving both temporary insiders and the use of market information.”<sup>96</sup> Lower federal courts also applied the theory.<sup>97</sup> But the Fourth and Eighth Circuits rejected it.<sup>98</sup> As such, many were left wondering how the misappropriation theory would fare in the long run.<sup>99</sup>

The Supreme Court heard the appeal of the Eighth Circuit’s rejection of the misappropriation theory in *United States v. O’Hagan*.<sup>100</sup> In *O’Hagan*, an attorney for a firm working on a potential tender offer traded on information gained through his firm’s representation of the acquirer.<sup>101</sup> O’Hagan was charged with and convicted of, among other counts, securities fraud, but a divided panel of the Eighth Circuit reversed his conviction based on a rejection of the misappropriation theory.<sup>102</sup>

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94. *Id.* at 26. In contrast, Judge Miner, dissenting in the Second Circuit’s decision in the case, stated, “[t]o say that the ‘publication schedule’ of the *Wall Street Journal* was the non-public, confidential information stolen by the defendants is to extend the sweep of section 10(b) and rule 10b-5 beyond all reasonable bounds.” *United States v. Carpenter*, 791 F.2d 1024, 1037 (2d Cir. 1986) (Miner, J., dissenting).

95. *Carpenter*, 484 U.S. at 24. The Court upheld the conviction on mail fraud. *Id.*; Karmel, *Outsider Trading*, *supra* note 41, at 93.

96. Karmel, *Outsider Trading*, *supra* note 41, at 92 (citations omitted). The Second, Seventh, and Ninth Circuits relied on the majority opinion in *Chiarella* when they adopted the misappropriation theory. See *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991) (en banc) (cautiously extending the misappropriation theory to “new relationships”); *SEC v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991) (extending the misappropriation theory to cover “outsiders” who would not normally be deemed fiduciaries); *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990) (applying the misappropriation theory to circumstances where the misappropriation involves violation of a fiduciary or similar duty).

97. DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, *SECURITIES LITIGATION AND ENFORCEMENT* 489–90 (2003) (“[T]he Second Circuit was quick to give [the misappropriation] theory a warm embrace. . . . Other Circuits soon followed.”) (citations omitted).

98. Karmel, *Outsider Trading*, *supra* note 41, at 93–94.

99. See Painter et al., *supra* note 16, at 157. Many were also confused because the majority opinion in *Chiarella* seemed “both over-inclusive and under-inclusive[.]” it extended a fiduciary duty to a context in which it was not recognized at common law, yet at the same time ignored the fact that the common law recognizes some duties to disclose that were very similar to the parity of information theory the majority seemed to reject. Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1655 (2004).

100. 521 U.S. 642 (1997).

101. *Id.* at 647. The indictment alleged that O’Hagan used the profits to repay client accounts from which he had embezzled money. *Id.* at 648.

102. *Id.* at 648–49. The Eighth Circuit stated that “neither the statutory language of section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), nor Supreme

The Supreme Court reversed,<sup>103</sup> holding that “criminal liability under § 10(b) may be predicated on the misappropriation theory.”<sup>104</sup> While Justice Ginsburg’s opinion applied a narrower version of the theory than some circuits embraced,<sup>105</sup> the Court held that misappropriators satisfy the deception requirement under Section 10(b) and Rule 10b-5 because they “deal in deception” in that they feign fidelity by “pretend[ing] loyalty to the principal while secretly converting the principal’s information for personal gain.”<sup>106</sup> Thus, like in the classical theory, the Court satisfied the fraud requirement of Rule 10b-5 by equating it to the breach of a fiduciary or fiduciary-like obligation, but now allowed this breach to satisfy the fraud requirement regardless of whether the breach related to the shareholders of the security being traded.<sup>107</sup> O’Hagan was a quintessential outsider because he worked for the firm representing the acquirer when he traded options of the target.<sup>108</sup> Therefore, while the Court still vested its decision in a breach of some relation of trust, this breach no longer had to involve a relationship between an insider of a company and its shareholders.<sup>109</sup>

In concluding that the misappropriation theory could support a conviction for securities fraud, *O’Hagan* distinguished *Chiarella* and *Dirks*.<sup>110</sup> The Court stated that *Chiarella* did not resolve the question

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Court precedent interpreting it, will support the use of the ‘misappropriation theory,’ the theory which formed the basis for O’Hagan’s § 10(b) securities fraud convictions.” *United States v. O’Hagan*, 92 F.3d 612, 613–14 (8th Cir. 1996), *rev’d*, 521 U.S. 642 (1997).

103. *O’Hagan*, 521 U.S. at 650 & n.3.

104. *Id.* at 650.

105. *Roundtable on Insider Trading*, *supra* note 40, at 11 (Professor Marcel Kahan, New York University School of Law).

106. *O’Hagan*, 521 U.S. at 653. Thus, the victim in a misappropriation case is the source of the information rather than the shareholders or investors.

107. *Id.* at 652–53.

108. *Id.* at 647, 653 n.5.

109. *Id.* at 652–53. Moreover, the Chief Justice’s dissent in *Chiarella* foretold the potential for this much broader application. *Chiarella v. United States*, 445 U.S. 222, 240–41 (1980) (Burger, C.J., dissenting); *see also* *SEC v. Rocklage*, 470 F.3d 1, 6–7 (1st Cir. 2006) (discussing the misappropriation theory) (citing *Chiarella*, 445 U.S. at 231–35 and *O’Hagan*, 521 U.S. at 652).

Under the misappropriation theory, as in the classical theory, the insider trader received the inside information legally and through no breach of trust or relationship. The illegality arises from the fact that the trader used for himself the confidential information belonging to someone else. *Rocklage*, 470 F.3d at 16 (citing *O’Hagan*, 521 U.S. at 652). That use of the confidential information without informing its owners constitutes the deceptive act required under Rule 10b-5. *Id.* Therefore, as the First Circuit recently stated, under the Supreme Court’s formulation of the misappropriation theory, the misappropriator can avoid liability through the “safe-harbor” of disclosing his intentions to the owner of the information. *Id.* at 12.

110. *O’Hagan*, 521 U.S. at 660–63.

of liability under the misappropriation theory.<sup>111</sup> The Court explained that its language in *Chiarella* that could be read as limiting liability under Section 10(b) actually rejected only the idea that the Section imposes an *absolute* duty between *all* market participants while “carefully leaving for future resolution the validity of the misappropriation theory . . . .”<sup>112</sup>

Similarly, the Court stated that *Dirks* did not foreclose the application of the misappropriation theory because the case considered tippee liability rather than misappropriator liability under Section 10(b). The Court distinguished *Dirks* because the *Dirks* tippee was not expected to keep the information confidential and because he did not misappropriate or illegally obtain the information.<sup>113</sup> Thus, the *O’Hagan* Court found that the *Dirks* decision also did not reject the misappropriation theory.<sup>114</sup>

This new misappropriation theory extends liability for securities violations beyond classical insiders<sup>115</sup> to those who misappropriate material, nonpublic information for use in a securities transaction in violation of some fiduciary or fiduciary-like duty that they owe to a party, regardless of whether that party issues or trades any of the illegally traded stock.<sup>116</sup> In other words, for the first time, the breach of a fiduciary or fiduciary-like relationship need not be directed at the company whose stock was traded for the breach to satisfy the fraud requirement of Rule 10b-5.<sup>117</sup>

The scope of this expansion cannot be underestimated. But the Supreme Court did little to aid the lower courts in logically defining

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111. *Id.* at 661–62.

112. *Id.* at 662.

113. *Id.* at 662–63.

114. *Id.* at 663. The Court asserted that because the case considered only the liability of a tippee, *Dirks* did not foreclose the adoption of the misappropriation theory. *Id.*

115. Some have called these people “outsiders” because they are not inside the company whose securities were traded. See *SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990) (defining outsiders as “persons who are neither insiders of the companies whose shares are being traded, nor tippees of such insiders”).

116. *Id.*

117. *O’Hagan*, 521 U.S. at 652–53. According to the Supreme Court,

a person commits *fraud* . . . and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, a fiduciary’s undisclosed, self-serving use of a principal’s information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, *defrauds* the principal of the exclusive use of that information.

*Id.* at 162 (emphasis added).

the contours of the fledging misappropriation theory.<sup>118</sup> Indeed, some criticize the current version of the misappropriation theory because it “does nothing for the confidence of a particular investor [because] liability is untethered to conduct harming investor confidence.”<sup>119</sup>

### III. RULE 10B-5 AND “MERE THIEVES”<sup>120</sup>

Conventional wisdom had held that mere thieves cannot be liable for trading on stolen confidential information because they lack a fiduciary relationship to the source of the information and, therefore, do not deceive that source.<sup>121</sup> At least one commentator, however, admits that the misappropriation theory could extend to situations in

118. Painter et al., *supra* note 16, at 187 (“Once the Court decided that corporate outsiders in possession of material, nonpublic information have no duty to disclose that information to the persons with whom they trade, the Court foreclosed any logical way to reach trading by such outsiders under Section 10(b).”).

119. Bach T. Hang, Note, *The SEC’s Criminal Rulemaking in Rule 10b5-2: Incarceration Should be Made of Sterner Stuff*, 41 WASHBURN L.J. 629, 630 (2002). The author goes substantially further by stating that “the SEC periodically generates headlines announcing that some poor soul has been charged with insider trading. The Theory exists to sacrifice bodies and careers on the altar of investor confidence.” *Id.*; see also Smith, *supra* note 3, at 1015 (stating that “the concepts of market integrity and fairness are at the mercy of a technicality”). Further, “[i]t is also hard to justify the disparate treatment between two people who trade on nonpublic information and create the same degree of harm on the every day investor based solely on the source of their nonpublic information.” *Id.* at 1014–15.

120. The term “mere thieves” could encompass a number of persons, including computer hackers who obtain confidential information about upcoming mergers or transactions, burglars who steal such information, or someone who steals documents out of another’s briefcase while that person is out of the room.

121. Painter et al., *supra* note 16, at 181; Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1526–27 (1999) (arguing that “Rule 10b-5 simply does not bar the use of unlawfully acquired information,” and, therefore, the misappropriation theory does not apply to mere thieves because they do not actually deceive anyone); Smith, *supra* note 3, at 1014 (“Under *O’Hagan’s* [sic] version of the misappropriation theory, a person may avoid liability by . . . obtaining the information by theft if one is not standing in a fiduciary relationship with the source . . . .”); see Nagy, *supra* note 3, at 1255 (opining that “it is doubtful that securities trading by the computer hacker or the ‘mere’ thief would violate Section 10(b) and Rule 10b-5, because neither scenario would involve misappropriation through acts that would constitute affirmative deception”); see also Bayne, *supra* note 2, at 64 (recognizing that under the Original Theory, “Mere Thieves had no Duty to forgo the Insider Trade. Only Trusted Thieves were held to a Duty under Section 10(b)”); Randall W. Quinn, Comment, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O’Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 894 (2003) (arguing that mere thieves are not liable unless they are former employees who manage to steal information as imposters). *But see Roundtable on Insider Trading, supra* note 40, at 31 (Judge Ralph K. Winter, United States Court of Appeals for the Second Circuit) (suggesting that judges interpreting *O’Hagan* “will hold that if [a] trader steals [a] briefcase from [a] lawyer and uses the information in it[, then] he has misappropriated it and . . . it will be a 10b-5 violation”).

which there is an element of intentional deception related to the trade, but no fiduciary relationship.<sup>122</sup> Moreover, some scholars argue that there should be a duty to disclose any information obtained via an illegal act,<sup>123</sup> regardless of “[w]hether one calls this a misappropriation or not.”<sup>124</sup> Finally, while some have suggested that these mere thieves do not create a problem worthy of attention,<sup>125</sup> the fact that the SEC recently addressed the issue demonstrates that mere thieves are in fact a serious concern.

In *SEC v. Lohmus Haavel & Viisemann*,<sup>126</sup> the SEC sued Lohmus Haavel & Viisemann (LHV), an Estonian investment company, and two LHV employees, alleging that the defendants hacked into a website and stole investment-related press releases before they were publicly disseminated.<sup>127</sup> The defendants then allegedly traded on the stolen information.<sup>128</sup> One defendant filed a motion to dismiss, asserting that the SEC failed to allege sufficient facts for a fraud viola-

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122. DONALD C. LANGEVOORT, *INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION* § 6.14 (2007).

123. See Karmel, *Outsider Trading*, *supra* note 41, at 109 (asserting that the misappropriation theory is too narrow to prevent trading on information obtained by illicit means); Nagy, *supra* note 3, at 1252 (arguing that the misappropriation theory as adopted in *O'Hagan* is much too narrow to accommodate more sophisticated cases, including those involving mere thieves). Some have gone even further and argued that although Rule 10b-5 could be read as protecting only those who can be classified as investors, it has been “stretched” to cover other persons. Thomas Lee Hazen & David L. Ratner, *The Jurisprudence of SEC Rule 10b-5*, [http://d2d.ali-aba.org/\\_files/thumbs/rf/35Hazen10b-5CG010\\_thumb.pdf](http://d2d.ali-aba.org/_files/thumbs/rf/35Hazen10b-5CG010_thumb.pdf) (last visited Apr. 9, 2008). This argument suggests not only that the fraud on investors approach applies, but also that the protection of those traditionally thought to be protected under the Rule (the sources of the information) are actually *extensions* of the Rule rather than the basis for the Rule.

124. LANGEVOORT, *supra* note 122, § 6.14.

125. See Quinn, *supra* note 121, at 895–96, 895 n.163 (discussing commentators who argue that Rule 10b-5 should not apply to thieves trading based on stolen securities information).

126. No. 05-CV-9259 (S.D.N.Y. May 30, 2007).

127. Complaint, *supra* note 5, at 1–2. The defendants electronically stole confidential information from Business Wire, a company that collects, edits, and disseminates press releases from its clients to the public. *Id.* at 5–6. The information obtained in *Lohmus Haavel & Viiseman* included the identity of the issuer, the purpose and substance of the release, and the schedule for release to the public. *Id.* at 8.

128. *Id.* at 2. The Complaint alleged as follows:

In connection with more than 360 confidential press releases issued by more than 200 U.S. public companies, defendants LHV, Peek, and Lepik, through a series of fraudulent acts, repeatedly have electronically stolen material non-public information from a secure website for the purpose of executing hundreds of securities trades based on that information, successfully making at least \$7.8 million in the process.

*Id.* The SEC was alerted to the scheme when several accounts experienced higher than normal trading prior to a particular merger. *Id.* at 4. In short, if the release contained positive information, then the defendants would purchase the security or call option; if the

tion under Section 10(b) or an insider trading violation under Rule 10b-5.<sup>129</sup> This case provided the first opportunity for the court to apply Rule 10b-5 liability to mere thieves. The court issued a preliminary injunction in favor of liability, but did not issue a final disposition because the defendants settled without admitting or denying liability.<sup>130</sup>

Thereafter, in *SEC v. Blue Bottle Ltd.*,<sup>131</sup> the Southern District of New York again faced the issue of whether stealing/hacking and trading amounts to a violation of Rule 10b-5. Again, the court issued a preliminary injunction initially supporting liability for mere thieves.<sup>132</sup> The case concluded with a verdict of liability under 10b-5, but was decided by default judgment without opinion.<sup>133</sup>

Finally, just a few months ago, in *SEC v. Dorozhko*, the Southern District of New York confronted this issue for a third time.<sup>134</sup> In *Dorozhko*, a Ukrainian man allegedly hacked into a computer system of a NYSE-listed company's investor relations firm, stole confidential information, and traded on it.<sup>135</sup> This time, however, the trial court held that stealing/hacking and trading does *not* violate Rule 10b-5—distinguishing the district's prior two inchoate cases.<sup>136</sup>

The remainder of this Article presents a jurisprudential analysis demonstrating that "mere thieves" violate Rule 10b-5 when they trade on stolen, confidential financial information, whether viewed as simple fraud or insider trading.

Moreover, good policy supports this growing course of case law. Applying 10b-5 liability to mere thieves promotes consistency because thieves cannot avoid criminal liability for trading on stolen, nonpublic information.<sup>137</sup> Full application of Rule 10b-5 to mere thieves prop-

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information was negative, then they would effectuate a short sale of the security or buy a put option. *Id.* at 10–11.

129. Memorandum of Law in Support of Oliver Peek's Motion to Dismiss the Complaint and to Vacate the Order of Preliminary Injunction, Freeze of Assets and Other Relief at 1–3, *SEC v. Lohmus Haavel & Viisemann*, No. 05-CV-9259 (S.D.N.Y. May 30, 2007).

130. The settlement required the defendants to refrain from violating Rule 10 and to disgorge their \$13 million in profits. Litigation Release No. 20134, U.S. Securities and Exchange Commission, Court Issues Final Judgment by Consent Against Defendants Oliver Peek and Lohmus Haavel & Viisemann (May 31, 2007), <http://sec.gov/litigation/lit-releases/2007/lr20134.htm>.

131. No. 07-CV-1380 (CSH) (S.D.N.Y. Feb. 26, 2007), *cited in* *SEC v. Dorozhko*, No. 07-Civ-9606 (NRB), 2008 WL 126612, at \*17 (S.D.N.Y. Jan. 8, 2008).

132. *Id.*

133. *Id.*

134. No. 07-Civ-9606 (NRB), 2008 WL 126612 (S.D.N.Y. Jan. 8, 2008).

135. *Id.* at \*1.

136. *Id.* at \*2.

137. See Kimberly D. Krawiec, *Fiduciaries, Misappropriators and the Murky Outlines of the Den of Thieves: A Conceptual Continuum for Analyzing United States v. O'Hagan*, 33 *TULSA L.J.* 163,

erly orders penalties for wrongdoers by recognizing that the misconduct committed by thieves is more culpable than that committed by employees. While the Seventh Circuit in *SEC v. Cherif* reached the opposite conclusion, stating that a person owing a fiduciary-type duty "betray[s] a trust in a way that a mere thief does not,"<sup>138</sup> this conclusion seems misguided. The distinction should not benefit thieves because, whereas a person with a fiduciary interest obtains information lawfully and uses it unlawfully, a thief both obtains and uses information unlawfully. Therefore, the thief should be punished more, not less, than the person who obtained the information legally.<sup>139</sup>

### A. *Simple Fraud*

Federal statute defines "[f]raud and related activity in connection with computers" as "intentionally access[ing] a computer without authorization or exceed[ing] authorized access, and thereby obtain[ing] . . . information from any protected computer if the conduct involved an interstate or foreign communication."<sup>140</sup> Hacking is one of the most likely methods by which mere thieves steal confidential information from companies with whom they are otherwise unrelated. Thus, given that federal statute explicitly defines this behavior as fraud,<sup>141</sup> the argument that mere thieves in the context of computer hacking are liable under Rule 10b-5's simple fraud prohibition is convincing.

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172-73 (1997) (commenting that the misappropriation theory focuses on protecting investors from being "unfairly cheated" by trades made by those with "informational advantages").

138. 933 F.2d 403, 412 (7th Cir. 1991).

139. This distinction was cleverly outlined in Professor Painter's classroom Honor Code after the *O'Hagan* case:

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

Painter et al., *supra* note 16, at 153.

140. 18 U.S.C. § 1030(a)(2) (2000 & Supp. V 2005). The statute is also cited in Plaintiff's Response, *supra* note 5, at 11.

141. The fact that the federal statute defines hacking as fraud is helpful, but it is not necessary; the SEC has stated that Section 10(b) and Rule 10b-5 are "not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others." Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961). As such, Section 10(b) and Rule 10b-5 were drafted as broad remedial provisions directed toward misleading or deceptive practices, regardless of whether they were technically sufficient to satisfy the common law (or statutory) requirements for fraud or deceit. *Id.* at 910.

By analogy, if a thief *physically* breaks into a corporation's headquarters, steals confidential information, and trades on it, Rule 10b-5(a) equally applies.<sup>142</sup> Physical entry, like computer hacking, typically requires deception to access/remove the secret information, as the thief would need to mislead the security (be it human or electronic) protecting the confidential information.<sup>143</sup>

While surreptitious thievery is not universally viewed as fraud, it certainly can be. For example, Rule 609 of the Federal Rules of Evidence, and most comparable state rules, permit a party to impeach a witness with a prior conviction involving "dishonesty or false statement."<sup>144</sup> In this context, one court stated that "[t]he crime of shoplifting [essentially defined as surreptitious thievery] . . . is dishonest and contains elements of deceit."<sup>145</sup> This opinion suggests a similar outcome for defining mere thievery as fraud under Rule 10b-5. While there is a split of authority regarding "whether theft crimes such as . . . shoplifting should be categorized as *crimen falsi*, [and] historically they have *not* been,"<sup>146</sup> the standard of "dishonesty or false statement" is much narrower than the fraud and deceit element of Rule 10b-5. Courts have been far more willing to broadly interpret the elements of Rule 10b-5 than they have been in relaxing the standards for the admission of impeachment evidence.<sup>147</sup> As such, courts would not be dramatically altering the legal landscape of insider trading jurisprudence by including thievery within the rubric of 10b-5 fraud.

### B. Insider Trading

In addition to analyzing a simple fraud claim, it is valuable to examine whether mere thieves violate the insider trading prohibition of Rule 10b-5 because insider trading liability gives rise to treble dam-

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142. See Quinn, *supra* note 121, at 894–95, for a brief discussion of when a thief might and might not be engaging in deception. What remains an open question, perhaps, is an obvious invasion of a company and theft of information. Such an act may not satisfy any of the fraud or deception elements of Rule 10b-5, although it seems an unlikely method of acquiring such confidential information. Cf. STEPHEN M. BAINBRIDGE, *SECURITIES LAW: INSIDER TRADING* 116 (2d ed. 2007) (see section entitled "Liability for brazen misappropriators").

143. See *Cady, Roberts & Co.*, 40 S.E.C. at 910 (concluding that Section 10(b) and Rule 10b-5 should be read broadly to target all misleading or deceptive activities); see also BAINBRIDGE, *supra* note 142, at 3 (discussing Rule 10b-5 securities fraud liability based upon either "deception" or "manipulation").

144. FED. R. EVID. 609(a); *Laird v. State*, 755 So. 2d 489, 491 (Miss. Ct. App. 1999).

145. *Laird*, 755 So. 2d at 491.

146. *Id.* (emphasis added).

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

ages in enforcement actions, while simple fraud claims do not.<sup>148</sup> For years, courts have attempted to address insider trading under Rule 10b-5 on an ad-hoc basis, rarely dealing squarely with corporate theft.<sup>149</sup> As a result, courts have infrequently discussed whether mere thieves of confidential information violate the Rule by trading on stolen, nonpublic material information. This section discusses the language of Rule 10b-5, the policy behind it, and the relevant case law interpreting and developing insider trading jurisprudence in order to demonstrate that mere thieves are liable for insider trading under the Rule.

The classical theory began the complicated topology of insider trading jurisprudence,<sup>150</sup> and the landscape expanded with the continually growing misappropriation theory.<sup>151</sup> And, while the misappropriation theory has been accepted, the limits of its application remain unclear to courts, commentators, potential victims, and violators.<sup>152</sup> The following subsections analyze whether the misappropriation theory still requires a fiduciary or fiduciary-like duty and, if not, whether mere thieves violate Rule 10b-5 under the misappropriation theory.

### 1. *Beyond Fiduciary Relationships*

*O'Hagan* and its progeny should not be read as requiring a fiduciary relationship under the misappropriation theory.<sup>153</sup> Both the un-

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148. *Roundtable on Insider Trading*, *supra* note 40, at 37 (Ralph K. Winter, Judge, United States Court of Appeals for the Second Circuit) ("You can get treble damages and attorneys' fees."); *compare* 15 U.S.C. §78u-1(a) (2000) *with* 15 U.S.C. §78u(d) (2000 & Supp. V 2005).

149. The SEC, not surprisingly, has been less reticent in setting forth its position on this issue. *See, e.g.*, *Investors Mgmt. Co.*, 44 S.E.C. 633, 641 n.18 (1971) ("Our formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like.").

150. *See* Pritchard, *supra* note 47, at 14–15 (discussing that the Court's decisions in *Chiarella v. United States* and *SEC v. Dirks* were the first to pronounce law on insider trading, establishing the classical theory).

151. Craig W. Davis, *Misappropriators, Tippees and the Intent-to-Benefit Rule: What We Can Still Learn from Cady, Roberts*, 35 SETON HALL L. REV. 263, 296 (2004).

152. *See* *United States v. Kim*, 184 F. Supp. 2d 1006, 1014 (N.D. Cal. 2002) ("[T]he SEC release described the law . . . regarding the scope of misappropriation liability as 'unsettled.'"); Donald C. Langevoort, *Rule 10b-5 as an Adaptive Organism*, 61 FORDHAM L. REV. S7, S7 (1993) ("Rule 10b-5's survival is largely due to the flexibility of its language which has enabled the rule to embrace malleable social perceptions of the securities market and the securities business.").

153. *Roundtable on Insider Trading*, *supra* note 40, at 27 (Professor Marcel Kahan, New York University School of Law) ("[T]he way I read *O'Hagan*, it does not take a fiduciary duty to misappropriate.").

derlying purpose of the misappropriation theory and courts' interpretation of it demonstrate that the theory encompasses the acts of nonfiduciaries.<sup>154</sup> Justice Blackmun agreed in his *Chiarella* dissent, stating that:

persons having access to confidential material information that is not legally available to others generally are prohibited

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154. See, e.g., Prakash, *supra* note 121, at 1511, 1514 (opining that “[f]iduciary breaches are not only insufficient for Rule 10b-5 liability, they are not even necessary,” and that “we must abandon our unwarranted fixation on fiduciary breaches and acknowledge that Rule 10b-5 actually targets deceptions”). Professor Prakash also suggests that despite our fixation on and fascination with insider trading, a large body of case law premises Rule 10b-5 liability on situations not involving material, nonpublic information or breach of fiduciary duty. *Id.* at 1536. One commentator has even gone so far as to describe the fiduciary duty “requirement” as “the deus ex machina”—i.e., “the god out of a machine.” David Cowan Bayne, *Insider Trading and the Misappropriation Theory: The Awakening*, 1995, 30 *LOU. L.A. L. REV.* 487, 503 (1997) [hereinafter Bayne, *The Awakening*]. But see *SEC v. Kornman*, 391 F. Supp. 2d 477, 484 (N.D. Tex. 2005) (agreeing that no fiduciary duty is required, but suggesting that at least a fiduciary-like relationship need be present for liability under the misappropriation theory). The court explained that there is

“no general duty between all participants in market transactions to forgo actions based on material nonpublic information”; rather, the “misappropriation theory bars only trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or *similar obligation* to the owner or rightful possessor of the information.”

*Id.* at 484 (quoting *United States v. O'Hagan*, 521 U.S. 642, 663 (1997)) (emphasis added). One commentator asserts:

The law of Insider Trading is exactly where it was on the day the Eighth Circuit handed down *O'Hagan*. The Ginsburg Opinion never directly faced the concise question posed by the five Circuits: Does the Misappropriation Theory conform to Section 10(b)?

Because Justice Ginsburg avoided this question judicially, and founded her holding on a New Theory not before the Court, all else about the Misappropriation Theory itself is obiter.

Bayne, *supra* note 2, at 1–2. Bayne found support for his position in Justice Thomas's dissenting opinion in *O'Hagan*:

[The Ginsburg Majority] engages in the “imaginative” exercise of constructing its own misappropriation theory from whole cloth. . . . [This] new theory . . . suffers from a . . . dispositive flaw: It is not the theory offered by the Commission. Indeed, . . . this . . . completely novel . . . theory has never been proposed by the Commission, much less adopted by rule or otherwise.

*Id.* at 1 (quoting *O'Hagan*, 521 U.S. at 687 (Thomas, J., concurring in judgment in part and dissenting in part)). However, Bayne's conclusion might have been colored by his less-than-favorable view of the misappropriation theory, which is evident in his admonition to the SEC: “Stop pandering to the illogical [Misappropriation] Theory, . . . [and] [r]eturn to your roots. In memory of Chairman Cary, resurrect his excellent *Cady, Roberts* . . . . Attack the remaining errors that burden the traditional law imposed by some of the errant *Cady, Roberts* progeny.” Bayne, *The Awakening, supra*, at 533. Bayne argued that the Fourth Circuit decision in *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995), which held that the misappropriation theory is not valid, *id.* at 952, is “a watershed and the beginning of a new era, a return to sanity and the long-successful, traditional years of *Cady, Roberts* . . . .” Bayne, *The Awakening, supra*, at 489–90.

by Rule 10b-5 from engaging in schemes to exploit their structural informational advantage through trading in affected securities. To hold otherwise . . . is to tolerate a wide range of manipulative and deceitful behavior.<sup>155</sup>

The subsequent development of the misappropriation theory supports Justice Blackmun's view. Under the Second Circuit's pre-*O'Hagan* version of the misappropriation theory, the Court of Appeals held in *United States v. Chestman*<sup>156</sup> that more than a mere familial relationship must be shown to create a 10b-5 fiduciary relationship<sup>157</sup> that could be "breached" through the use of confidential information.<sup>158</sup> Three years after *O'Hagan*, however, the SEC felt emboldened by the Supreme Court's endorsement and promulgated Rule 10b5-2 in response to limitations on the misappropriation theory suggested in *Chestman*.<sup>159</sup> In Rule 10b5-2, the SEC defined the misappropriation theory to cover three, *nonexclusive*, specific situations in which a duty exists to keep information confidential.<sup>160</sup>

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155. *Chiarella v. United States*, 445 U.S. 222, 251 (1980) (Blackmun, J., dissenting).

156. 947 F.2d 551, 567 (2d Cir. 1991) (recognizing the Second Circuit's prior acceptance of the misappropriation theory, but noting that the court would "tread cautiously in extending the misappropriation theory to new relationships").

157. *Id.* at 568, 570-71. In *Chestman*, Ira Waldbaum, the president and controlling shareholder of the eponymous supermarket, decided to sell his shares to a competing chain for a significant premium. *Id.* at 555. Waldbaum told one relative, who told another, and so on. Each person told the next to keep the information confidential. *Id.* The penultimate recipient then provided an edited version to his stockbroker, Chestman, who traded on it. *Id.* The Court held that "a person violates Rule 10b-5 when he misappropriates material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence and uses that information in a securities transaction." *Id.* at 566. However, as discussed, the court found that the familial relationship alone did not satisfy the relationship test. *Id.* at 568, 570-71.

158. *See SEC v. Materia*, 745 F.2d 197, 199 (2d Cir. 1984) (upholding the trial court's decision that the misappropriation and trading of material nonpublic information violates Rule 10b-5).

159. WILLIAM A. KLEIN, J. MARK RAMSEYER, & STEPHEN M. BAINBRIDGE, *BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS* 508 (2003).

160. 17 C.F.R. § 240.10b5-2 (2007). This rule contains the following preliminary note:

This section provides a non-exclusive definition of circumstances in which a person has a duty of trust or confidence for purposes of the "misappropriation" theory of insider trading under Section 10(b) of the Act and Rule 10b-5. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5, and Rule 10b5-2 does not modify the scope of insider trading law in any other respect.

*Id.* Further, the rule specifies the following three "duties of trust or confidence," which exist "among others":

- (1) Whenever a person agrees to maintain information in confidence;
- (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasona-

Specifically, Rule 10b5-2 states that if a “person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling,” she presumably has a “duty of trust or confidence . . . with respect to the information . . . .”<sup>161</sup> In addition, the rule specifies that a trust relationship subject to Rule 10b-5 exists *whenever* someone agrees to keep information in confidence or when parties have a practice of sharing secrets such that the recipient of the confidential information knows or should know that the provider of the information expects confidentiality.<sup>162</sup> The SEC stated that the misappropriation theory applies to breaches of these “non-business relationships”<sup>163</sup> even though they are not fiduciary relationships.

Indeed, before enacting Rule 10b5-2, the SEC long argued that the misappropriation theory extends beyond direct business relationships;<sup>164</sup> the SEC’s position did not even envision the necessity of a fiduciary-like relationship.<sup>165</sup> In *Cady, Roberts*, for example, the SEC asserted that the classes of people obligated to disclose material facts

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bly should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality; or

(3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling; *provided*, however, that the person receiving or obtaining the information may demonstrate that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because of the parties’ history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

*Id.*

161. 17 C.F.R. § 240.10b5-2(b)(3) (2007).

162. *Id.* § 240.10b5-2(b)(1)–(2).

163. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,729–30 (Aug. 24, 2000).

164. *Id.*; see also *supra* note 85 and accompanying text; *infra* text accompanying note 230 (stating the SEC’s proposed definition of insider trading).

165. Some have stated that “Rule 10b5-2 expands the boundaries of fiduciary relationships to the point that ‘suggests that the misappropriation theory is not about fiduciary relationships at all.’” Smith, *supra* note 3, at 1022 n.136 (quoting D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1422 (2002) [hereinafter Smith, *The Critical Resource Theory*]). Gordon Smith states that Rule 10b5-2 “is about regulating information dissemination in securities markets, and the animating principle is one of equal access” to information. Smith, *The Critical Resource Theory*, *supra*, at 1422. Smith’s assertion indicates support of a fraud-on-the-market approach rather than a fraud-on-the-source approach. *Contra* Hang, *supra* note 119, at 659 (“Like its judicial predecessors, Rule 10b5-2 is not ‘well-tuned to an animating purpose of [the 1934 Act]: to insure [sic] honest securities markets and thereby promote investor confidence.’ . . . [It] does not turn on the effects of damage to the marketplace or buyers and sellers of securities.” (quoting *United States v. O’Hagan*, 521 U.S. 642, 658 (1997))).

extends beyond corporate officers.<sup>166</sup> The SEC maintained that the obligation exists if two elements are present: (1) “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 (2) “the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.”<sup>167</sup> According to the SEC, *anyone* satisfying these elements must either disclose or abstain from trading.<sup>168</sup>

In enacting Rule 10b5-2 after *O'Hagan*, the SEC explicitly stated that this broader definition of confidential relationships better reflects the purpose of the insider trading laws,<sup>169</sup> which includes “protect[ing] investors and the fairness and integrity of the nation’s securities markets against improper trading on the basis of inside information.”<sup>170</sup>

Of course, the SEC’s interpretation is not binding law; indeed, the SEC has a vested institutional interest in broad readings of the rules that govern its ability to regulate market participants.<sup>171</sup> This bias notwithstanding, courts grant deference to SEC views, even if they do not control.<sup>172</sup> And, once adopted by the courts, the SEC’s views certainly are law.

Those few courts that addressed Rule 10b5-2 essentially endorsed the evisceration of the fiduciary-duty requirement of the misappropriation theory. The Eleventh Circuit, in *SEC v. Yun*,<sup>173</sup> cited Rule 10b5-

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166. See *supra* note 86 and accompanying text.

167. *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961); see also *supra* note 84 and accompanying text.

168. *Cady, Roberts*, 40 S.E.C. at 912. The SEC stated that an insider has “the affirmative duty to make appropriate disclosures or dissociate himself from the transaction.” *Id.*

169. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,729 (Aug. 24, 2000).

170. *Id.*

171. See *United States v. Lang*, 766 F. Supp. 389, 400 (D. Md. 1991) (noting that a central purpose of Section 10(b) was to enable the SEC “to deal with new manipulative [or cunning] devices” in a flexible, non-restrictive manner) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201–03 (1976)) (internal quotation marks omitted).

172. *United States v. Kim*, 184 F. Supp. 2d 1006, 1014 (N.D. Cal. 2002) (“While the SEC’s opinion is not binding on this Court, it is persuasive given the SEC’s role in the development of insider trading law through rule making and its enforcement responsibilities.”).

173. 327 F.3d 1263 (11th Cir. 2003). During negotiations for post-nuptial division of assets, David Yun, the president of Scholastic Book Fairs, Inc., told his wife, Donna Yun, that the price of Scholastic shares would drop on a certain date, and he told her to keep the information confidential. *Id.* at 1267. While Donna was discussing this information with her divorce attorney on the telephone in her office, a co-worker entered her office and overheard the information; Donna later discussed the information with that co-worker

2 as support for its interpretation of the misappropriation theory that recognizes a duty to keep information confidential absent any explicit fiduciary duty.<sup>174</sup> The court held that a husband's reasonable expectation that his wife would keep certain material information confidential created a duty of confidentiality that satisfied the up-until-now fiduciary requirement of the misappropriation theory, even absent an explicit fiduciary duty.<sup>175</sup> The Eleventh Circuit rejected the Second Circuit's pre-*O'Hagan* view,<sup>176</sup> noting that a rule under which spouses presumptively do not have a duty under the misappropriation theory, "too narrowly defined the circumstances in which a duty of loyalty and confidentiality is created between husband and wife."<sup>177</sup> That idea was one of the expressly stated catalysts for the adoption of Rule 10b5-2.<sup>178</sup> Because the SEC promulgated Rule 10b5-2 after the trading in

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at a business function. *Id.* at 1268. The co-worker then traded based on that information. *Id.* For a general discussion of this case and its place in insider trading history, see M. Anne Kaufold, Note, *Defining Misappropriation: The Spousal Duty of Loyalty and the Expectation of Benefit*, 55 MERCER L. REV. 1489 (2004), which concluded that in *Yun*, the Eleventh Circuit settled two disputed theories of insider trading liability by requiring that, in insider trading misappropriation actions, the SEC prove that the alleged misappropriator actually intended to benefit from the tip. *Id.* at 1503.

174. *Yun*, 327 F.3d at 1273 n.23.

175. *Id.* at 1272-74. Specifically, the court stated that "a spouse who trades in breach of a reasonable and legitimate expectation of confidentiality held by the other spouse sufficiently subjects the former to insider trading liability." *Id.* at 1272-73. The court held that the SEC had provided sufficient evidence that the Yuns had "an agreement of confidentiality and a history or pattern of sharing and keeping of business confidences," that Yun agreed to maintain that confidentiality, and that Yun's husband had a reasonable expectation that Yun would keep the information confidential. *Id.* at 1273-74.

176. See *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991) (holding that marriage alone is not sufficient to create the requisite duty under the misappropriation theory despite one spouse trading in breach of the other spouse's reasonable expectation that the information would be kept confidential).

177. *Yun*, 327 F.3d at 1272.

178. Securities and Exchange Commission, Proposed Rule, Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,602 (proposed Dec. 28, 1999) (codified at 17 C.F.R. § 240.1065-2) states:

[T]he *Chestman* majority's approach does not fully recognize the degree to which parties to close family and personal relationships have reasonable and legitimate expectations of confidentiality in their communications. For this reason, we believe the *Chestman* majority view does not sufficiently protect investors and the securities markets from the misappropriation and resulting misuse of inside information.

*Id.* The SEC's statement of the final rule referenced this part of the Proposed Rule in its discussion of Rule 10b5-2. Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,729-30 (Aug. 24, 2000). Additionally, courts' discussion of Rule 10b5-2 demonstrate that the SEC intended to counteract the decision in *Chestman* by adopting this rule. The court in *Yun* quoted the previous language from the SEC's statement about the proposed rule and concluded that the SEC's intention to adopt the dissent's position in *Chestman* supported its determination that a duty of confidentiality existed between a husband and his wife when the husband had a reasonable expectation that the wife would keep material

*Yun* occurred, it did not apply.<sup>179</sup> Thus, the court's expansion of the misappropriation theory beyond explicit fiduciary duties arose independently of the rule, although it was informed by its purpose.

In *United States v. Kim*,<sup>180</sup> the defendant, a member of the Young Presidents Organization (YPO),<sup>181</sup> received information from another YPO member about a potential merger.<sup>182</sup> The members of the YPO were required to comply with a written "Confidentiality Commitment," which stated that "all information shared by the membership must be held in absolute confidence."<sup>183</sup> The court stated that Rule 10b5-2 would have applied had it been adopted before the criminal conduct occurred.<sup>184</sup> Because the court could not apply Rule 10b5-2, it held, citing *Chestman*, that the YPO member was not liable under the misappropriation theory.<sup>185</sup>

*Yun* and *Kim* demonstrate that the SEC's rulemaking authority expanded courts' views of the scope of liability under the misappropriation theory.<sup>186</sup> These cases also establish that courts have interpreted

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information confidential. *Yun*, 327 F.3d at 1273 n.23. Similarly, the court in *United States v. Kim* quoted this language and stated that "[t]he SEC's dissatisfaction with the law at the time as set forth in *Chestman* (which governs this case) is clear." 184 F. Supp. 2d 1006, 1014 (N.D. Cal. 2002).

179. *Yun*, 327 F.3d at 1273 n.23.

180. 184 F. Supp. 2d 1006 (N.D. Cal. 2002). For a critique of this case, see generally Nathan Heyde, Note, *Can You Keep a Secret? The "Similar Relationship of Trust and Confidence" in Misappropriation Theory: U.S. v. Kim*, 26 WHITTIER L. REV. 653 (2004), which highlights the flaws in the *Kim* court's analysis and application of the misappropriation theory.

181. *Kim*, 184 F. Supp. 2d at 1008.

182. *Id.*

183. *Id.*

184. *Id.* at 1014.

185. *Id.* at 1014–15. The court explained:

The defendant concedes that under the current regulation, which became effective August 24, 2000, the indictment alleges facts amounting to criminal misappropriation. The new regulation defines three non-exclusive circumstances under which "a person has a duty of trust or confidence for purposes of the 'misappropriation' theory of insider trading" for purposes of Rule 10b-5. They are: (1) Whenever a person agrees to maintain information in confidence; (2) Whenever the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern, or practice of sharing confidences . . . or (3) Whenever a person receives or obtains material nonpublic information from his or her spouse, parent, child, or sibling . . . . Both the first and second scenarios would apply to defendant's conduct in this case. The fact that the SEC saw a need to adopt this new rule adds force to the argument that the conduct it covers was not legally proscribed before adoption of the rule.

*Id.* at 1014 (citations omitted).

186. The opinion of a Texas district court further demonstrates this by stating that the "determination that the complaint has sufficiently alleged a fiduciary-like relationship to withstand Defendant's motion to dismiss is bolstered by the SEC's statements in adopting Rule 10b5-2 . . . [and] [t]hese allegations . . . bring this case within Rule 10b5-2(b)(1)."

the misappropriation theory as sufficiently broad to impose liability even in the absence of a fiduciary relationship. Moreover, despite some concern that the SEC overreached its authority in promulgating Rule 10b5-2,<sup>187</sup> the courts have ensconced the Rule in the contemporary legal landscape.

Courts and the SEC have emphasized that the Rule is nonexclusive and extends beyond those fiduciaries liable under the misappropriation theory.<sup>188</sup> But, up to that point, courts had still tethered liability to the existence of some duty of trust—however amorphous

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SEC v. Kornman, 391 F. Supp. 2d 477, 489–90 (N.D. Tex. 2005). The court held that the defendant who, in the process of unsuccessfully soliciting the opportunity to advise “executives in connection with their personal wealth management,” became privy to confidential information about the executives and their respective corporations, sufficiently satisfied the requirements of the misappropriation theory to survive a motion to dismiss. *Id.* at 492; see also Goldman, Sachs & Co., Exchange Act Release No. 48,436, 80 SEC Docket 2906 (Sept. 4, 2003), available at 2003 WL 22056978, at \*1, \*5–6 (holding that the defendant, a Washington, D.C.-based political consultant hired by Goldman Sachs, who attended a press conference with embargoed information, violated a duty of trust or confidence under Rule 10b5-2 when he told others that the Treasury Department was going to suspend future bond issuances before the Department made its official announcement). For further example, the United States District Court for the Southern District of New York accepted the guilty plea of a criminal defendant to one count of insider trading under Rule 10b5-2 based on the defendant’s trading on information obtained from his cohabitating girlfriend. *United States v. Edelman*, No. 06 CR 0002 (RWS), 2006 WL 1148701, at \*1, \*4 (S.D.N.Y. Apr. 24, 2006). In this case, Edelman was guilty of violating the rule because he breached a duty of trust and confidentiality based on a history, pattern, and practice of sharing confidences and a reasonable expectation that the confidentiality would be maintained. *Id.* at \*3–4.

187. See, e.g., BROMBERG & LOWENFELS, *supra* note 85, § 6:493 (opining that the “SEC’s proposal that certain family relationships or the sharing of confidences imposes a duty is far-reaching, controversial and open to question”); John J. Falvey, Jr., *The New SEC Rules on Insider Trading: The Criminal Implications*, 6 No. 13 ANDREWS SEC. LITIG. & REG. REP. 14, 18 (2001) (stating that “there remains a viable argument that the SEC’s effort in Rule 10b5-2 to define when such a duty exists in nonbusiness relationships exceeds its rule-making authority and effectively eliminates Section 10(b)’s requirement of breach of a fiduciary duty or its equivalent”); Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 492 (2002) (stating that Rule 10b5-2 “is outside of the SEC’s authority under Rule 10b-5”). Falvey noted, however, that this argument would have to overcome the courts’ high level of deference to the SEC’s rulemaking power under Section 10(b).

188. Some have argued that because of this fact, Rule 10b5-2 “has established the important doctrine of inside trading on a base of quicksand.” Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 DEL. J. CORP. L. 377, 461 (2004). Indeed, some commentators have even suggested that the SEC should argue for “friendship” to be a relationship covered by the breadth of Rule 10b5-2. For instance, Ethan J. Leib remarked that

nothing should necessarily stop a court from taking notice that strong personal relationships of friendship can be presumed to be confidential and can be the basis of misappropriation liability under Rule 10b5-2. The SEC has rejected *Chestman*—and those interested in having the law protect friendship could urge courts to recognize friendships’ duties of confidentiality in the 10b-5 insider trading context.

and all-encompassing that obligation may have been defined. This not-so-slow expansion of what satisfied the misappropriation theory's relationship test, however, reached a watershed point last year—resulting in the final death-knell to any relationship-of-confidence element of the misappropriation theory.

In *SEC v. Rocklage*,<sup>189</sup> the defendant, who shared with her brother nonpublic information that she received from her husband, despite her husband's indication that the information should remain confidential, did not even challenge the application of Rule 10b5-2.<sup>190</sup> The First Circuit affirmed<sup>191</sup> the lower court's refusal to dismiss the case for failure to state a claim that the wife utilized a "manipulative or deceptive device that was in connection with the purchase or sale of any security."<sup>192</sup>

In its discussion of the misappropriation theory, the *Rocklage* court explained:

"[T]he misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information." Such deceptive trading exploits unfair informational disparities in the securities market; making such trading illegal also comports with the congressional purposes underlying § 10(b).

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Finally, our interpretation finds further support in the investor protection purposes of § 10(b). One of the animating purposes of the statute was to "insure honest securities markets and thereby promote investor confidence." It furthers that purpose if the "in connection with" requirement reaches schemes in which one party deceptively and intentionally obtains material nonpublic information to enable another to trade with an unfair informational advantage.<sup>193</sup>

The *Rocklage* court's emphasis on the broad social purposes of Rule 10b-5's protection of the markets from traders with an "unfair informational advantage" and diminished focus on the specific, albeit

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Ethan J. Leib, *Friendship & the Law*, 54 UCLA L. REV. 631, 694 (2007); see also Grzebielski, *supra* note 187, at 468 ("This Article argues that the sharing of corporate information between family members and friends should be treated as if the information was acquired incident to a fiduciary relationship. Consequently, when the recipient of the information uses it to trade in securities, that person violates Rule 10b-5.").

189. 470 F.3d 1 (1st Cir. 2006).

190. *Id.* at 3, 7.

191. *Id.* at 14.

192. *Id.* at 3, 8 (internal quotation marks omitted).

193. *Rocklage*, 470 F.3d at 6, 10–11 (citations omitted) (citing *SEC v. Zandford*, 535 U.S. 813, 819–20 (2002); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997)).

often illusory, elements of the misappropriation test set the stage for the subsequent critical part of the court's analysis. Here, *Rocklage* discussed the "safe harbor" provision of *O'Hagan*,<sup>194</sup> which allowed misappropriators to avoid liability by disclosing the intention to trade to the party from whom the confidential information was acquired. This safe harbor exists under *O'Hagan* because the Supreme Court defined the deception requirement of Rule 10b-5 as the fiduciary's failure to disclose to the owner of the confidential information his intention to trade on that nonpublic material.<sup>195</sup> Pursuant to *O'Hagan*, therefore, a trader avoids violating Rule 10b-5 simply by disclosing his trading intentions to the source of the confidential information—even if the source strenuously objects—because no fiduciary obligation is breached.<sup>196</sup>

With this background, *Rocklage* stated:

The [Supreme] Court [in *O'Hagan*] did say, however, that "[b]ecause the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation." It is this language in *O'Hagan*, arguably *dicta*, on which defendants pin their argument: they contend that Mrs. Rocklage's disclosure to her husband eliminated any deception involved with her tipping, which would mean that her actions did not come within the text of § 10(b).<sup>197</sup>

*Rocklage* distinguished the *dicta* of *O'Hagan* to eviscerate the disclosure option under the misappropriation theory, stating that the defendant's pre-trade disclosure to her husband did *not* allow her to

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

195. *O'Hagan*, 521 U.S. at 655. The Court distinguished its holding in *Santa Fe Industries v. Green*, 430 U.S. 462, 479–80 (1977), in which the Court held that more than a mere breach of fiduciary duty is required for a Section 10(b) violation. In that case, however, there was full disclosure of the pertinent facts relating to the transaction. *Id.* at 474. This can lead to some interesting holdings. See, e.g., *Jensen v. Kimble*, 1 F.3d 1073, 1078–80 (10th Cir. 1993) (holding that an insider did not commit securities fraud when he asked a shareholder to sell him shares and told the shareholder that he had information relevant to the sale but would not disclose that information to the shareholder).

196. *Painter et al.*, *supra* note 16, at 180. Nevertheless, the *O'Hagan* Court also, and perhaps contradictorily, recognized that its misappropriation theory does not alleviate the problems caused by insider trading because it fails to ameliorate any of the harm to investors when the misappropriator discloses to the source that he or she plans to trade on the material, nonpublic information if the source does not disclose to the market. *O'Hagan*, 521 U.S. at 659 n.9.

197. *Rocklage*, 470 F.3d at 7 (citation omitted) (emphasis added).

avoid insider trading liability.<sup>198</sup> This fundamentally altered the legal basis for the misappropriation theory in a positive way.<sup>199</sup>

As such, *Rocklage* purged what was left of the fiduciary relationship requirement from the misappropriation test.<sup>200</sup> Liability under the misappropriation theory after *Rocklage* must be premised on something other than the “fraud” of failing to disclose the intention to trade on confidential information gained from a fiduciary or fiduciary-like relationship.

Of course, the Supreme Court can reverse *Rocklage*, and other circuits can simply ignore the decision. Indeed, as discussed above, one district court recently rejected the idea that a trader can violate Rule 10b-5 by “hacking into a computer network and stealing material non-public information.”<sup>201</sup> The court, unaided by the above analysis, held that

no federal court has *ever* held that the theft of material non-public information by a corporate outsider and subsequent trading on that information violates § 10(b). . . . To eliminate the fiduciary requirement now would be to undo decades of Supreme Court precedent, and rewrite the law as it has developed. It is beyond the purview of this Court to do so.<sup>202</sup>

Like the aforescribed theories of liability under Rule 10b-5, the Supreme Court will ultimately be called on to resolve this issue as well. Given the Supreme Court’s pattern of broadening liability for insider

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198. *Id.* at 12.

199. See BAINBRIDGE, *supra* note 41, at 120. As one noted commentator stated, “[a]lthough a misappropriator arguably deceives the source of the information [by failing to disclose], any such deception is quite inconsequential. The source of the information presumably is injured, if at all, not by th[is] deception, but by the conversion of the information by the misappropriator for his own profit.” *Id.* at 104–05.

200. The *Rocklage* court did attempt to distinguish its case from *O’Hagan* by asserting that the defendant-wife, Mrs. Rocklage, used deception to *acquire* the confidential financial information from her husband, rather than in the *use* of information—as was the case in *O’Hagan*. *Rocklage*, 470 F.3d at 3, 12. In describing the facts in *Rocklage*, however, the court articulated no relevant distinction between its case and *O’Hagan*. The *Rocklage* court pointed to two factors that qualified the defendant’s actions as deceptive *acquisition* of confidential information: (1) the defendant’s agreement to pass on to her brother any confidential information that she obtained from her husband; and (2) that she did not intend to maintain her husband’s confidences. *Id.* at 3. These factors identified by the *Rocklage* court as relating to the *acquisition* of confidential information (which appear identical in substance to each other), however, actually relate to the *use* of the information.

201. SEC v. Dorozhko, No. 07-Civ-9606 (NRB), 2008 WL 126612, at \*1 (S.D.N.Y. Jan. 8, 2008).

202. *Id.*

trading, the *Rocklage* view seems the more likely outcome and the correct jurisprudence.

After *Rocklage*, liability under the misappropriation theory, at least in the First Circuit, is premised on the parity-of-access theory alluded to in the *Chiarella* dissent.

## 2. *The Misappropriation Theory Reverts Back to Parity of Access*

“Conditioning liability on the existence of a fiduciary relationship le[ft] many unexplained gaps in insider trading enforcement [and] ma[de] what remains of the enforcement scheme unpredictable and possibly inconsistent . . . .”<sup>203</sup> The First Circuit’s holding that disclosure would not vitiate liability for trading on inside information under Rule 10b-5 moves misappropriation jurisprudence away from the fiduciary duty relationship test and back to a theory that fills these gaps and provides for more consistent application of the insider trading provisions, i.e., the parity-of-access theory.<sup>204</sup>

While the correlation between the misappropriation theory and the type of duty generally required before liability can attach has evolved,<sup>205</sup> *O’Hagan’s* adoption of a version of the dissent’s misappro-

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203. Painter et al., *supra* note 16, at 228; *see also* Theodore C. McCullough, Note, *United States v. O’Hagan: Defining the Limits of Fraud and Deceptive Pretext Under Rule 10b-5*, 22 SEATTLE U. L. REV. 311, 327 (1998) (arguing that the traditional focus on a fiduciary duty requirement fails to address the pervasiveness of insider trading as well as the ways in which nonfiduciaries can obtain inside information).

204. *United States v. O’Hagan*, 521 U.S. 642, 690 n.6 (1997) (Thomas, J., concurring in part and dissenting in part) (“As far as the market is concerned, a trade based on confidential information is no more ‘honest’ because some third party may know of it so long as those on the other side of the trade remain in the dark.”).

205. Smith, *The Critical Resource Theory*, *supra* note 165, at 1420 (“The most baffling intersection between fiduciary theory and insider trading law arises under the ‘misappropriation’ theory of insider trading.”). Indeed, “[t]he [misappropriation] theory has spawned an extraordinary body of cases as well as an even more extraordinary body of hypotheticals appearing in briefs, treatises, and law review articles exploring the extent and nature of the fiduciary relationship necessary to make a corporate outsider guilty of insider trading.” Painter et al., *supra* note 16, at 156. Furthermore, “each court interpreting the theory has envisioned a target of different size and shape, making the misappropriation theory intolerably vague.” *Id.* at 188; *see* Securities and Exchange Commission, Proposed Rule, Selective Disclosure and Insider Trading, 65 Fed. Reg. 51,716, 51,729, 51,738 (Aug. 24, 2000) (attempting to alleviate the problem of inconsistent case law by defining the circumstances under which a duty of trust or confidence exists); Securities and Exchange Commission, Proposed Rule, Selective Disclosure and Insider Trading, 64 Fed. Reg. 72,590, 72,591 (proposed Dec. 28, 1999) (codified at 17 C.F.R. § 240.1065-2) (proposing a three-part test for determining whether a duty of trust or confidence exists); Jonn R. Beeson, Comment, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1141-47 (1996) (discussing the problems with application of the misappropriation theory and advocating a regulatory solution); Grzebielski, *supra* note 187, at 467-68 (“[T]he scope of the Securities and Exchange Commission’s . . . prohibition

priation theory from *Chiarella* gave some credence to those dissenting Justices' arguments that any time a purchaser or seller of securities gains information via an illegal act, the trader has a duty to disclose or abstain, *regardless* of the existence of a fiduciary duty.<sup>206</sup> The essence of this position is the parity-of-access to information theory of liability for insider trading<sup>207</sup> that "all investors should have equal access to information that a reasonable investor would consider material to investment decisions, and that any trade in which only one party had an opportunity to learn and did learn such information is inherently unfair."<sup>208</sup> This doctrine derives from the "integrity of the market theory, which states [that] investors will be more confident and more likely to participate in the market if they feel confident they can trade without being at an informational disadvantage."<sup>209</sup> As one commentator suggested:

The rules have changed since the Supreme Court rejected the parity-of-[access to] information doctrine in *Chiarella* and *Dirks*. If the Securities Exchange Act's true objective is "to insure honest securities markets and thereby promote investor confidence" as Justice Ginsberg stated in *O'Hagan*, the courts should replace the fiduciary duty requirement in the fraud-on-the-source approach to the misappropriation theory with the parity-of-[access to] information doctrine and a fraud-on-the-market approach.<sup>210</sup>

The First Circuit effectively did this in *Rocklage*, returning the misappropriation theory to its judicial roots in the *Chiarella* dissent. Indeed, prior to the Supreme Court's decision in *O'Hagan*, the Fourth Circuit criticized the misappropriation theory being employed by other circuits, such as the Second and Seventh Circuits, forming the basis for the Supreme Court's more modest version of the misappropriation

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against trading in securities with material, nonpublic information under Rule 10b-5, remained unsettled.") (citation omitted); *see also* 2 BRENT A. OLSON, PUBLICLY TRADED CORPORATIONS: GOVERNANCE & REGULATION § 13:41 (2d ed. 2006) (discussing Rule 10b5-2).

206. *Chiarella v. United States*, 445 U.S. 222, 246-47 (1980) (Blackmun, J., dissenting); *see also id.* at 240-41 (Burger, C.J., dissenting) (stating that, to serve the policies underlying the rule, there should be a duty to disclose illegally obtained information).

207. *See SEC v. Rocklage*, 470 F.3d 1, 6-12 (1st Cir. 2006) (acknowledging that courts may impose liability when information is deceptively acquired).

208. *Dirks v. SEC*, 681 F.2d 824, 835 (D.C. Cir. 1982), *rev'd*, 463 U.S. 646 (1983); *see also Chiarella*, 445 U.S. at 233 (noting the possibility of a broad rule that imposes liability on anyone who participates in transactions "based on material, nonpublic information").

209. Smith, *supra* note 3, at 1026-27 (citing Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985)).

210. *Id.* at 1028 (citing Rule 10b5-2 as support for this argument) (citation omitted).

priation theory expressed in *O'Hagan*,<sup>211</sup> on the ground that the requirement for a breach of a fiduciary duty was illusory. As such, the Fourth Circuit recognized that the misappropriation theory would ultimately have to become some form of a parity-of-access theory for it to remain intellectually viable.<sup>212</sup>

Justice Blackmun recognized this point twenty-seven years ago in his *Chiarella* dissent. In *Chiarella*, he wrote that liability should attach whenever an illegal act yields access to confidential information, and the recipient does not abstain from trading or disclose to the source of the information, *regardless* of the existence of a fiduciary duty.<sup>213</sup> Blackmun would always hold mere thieves liable under Rule 10b-5 for insider trading.<sup>214</sup>

Indeed, the Seventh Circuit in *Cherif*, employing a modest variety of the misappropriation theory,<sup>215</sup> recognized the possibility of even that version applying to mere thieves:<sup>216</sup>

There has been some suggestion that Rule 10b-5 should apply even to "mere" thieves. See *Chiarella*, (Blackmun, J., dissenting) (suggesting that any time information is acquired by an illegal act, whether in breach of a fiduciary duty or not, there is a duty to disclose that information to the purchaser or seller with whom the acquirer trades); *Bateman Eichler, Hill Richards, Inc. v. Berner*, (suggesting that trading on "misappropriate[d] or illegally obtain[ed]" information constitutes

211. *United States v. O'Hagan*, 521 U.S. 642, 650 & n.3 (1997).

212. The Fourth Circuit concluded that the language of Section 10(b) and Rule 10b-5, the Supreme Court's interpretations of that language, and the purposes of those provisions did not support the adoption of the misappropriation theory. *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995). In *Bryan*, the Fourth Circuit noted:

[W]hile the courts adopting the misappropriation theory incant that the breach of a fiduciary relationship is a necessary element of the offense, in principle, if not in reality, these courts would be obliged to find liability in the case of simple theft by an employee, even where no fiduciary duty has been breached, for the *raison d'être* of the misappropriation theory in fact is concern over "the unfairness inherent in trading on [stolen] information."

*Id.* at 944 (quoting *Chiarella*, 445 U.S. at 241 (Burger, C.J., dissenting)).

213. *Chiarella*, 445 U.S. at 246-47 (Blackmun, J., dissenting).

214. *Id.*

215. *SEC v. Cherif*, 933 F.2d 403, 410-12 (7th Cir. 1991).

216. While the foregoing analysis brings mere thieves under the purview of insider trading liability via the courts' expansion of the misappropriation theory, mere thieves can, perhaps, also be subject to insider trading liability even under the old model of the misappropriation theory—as mere thieves can be viewed as having a fiduciary-like relationship with the owner of the stolen information. *Id.* at 412 n.6; LANGEVOORT, *supra* note 122, § 6.14, at n.5. The thief could be viewed as holding the misappropriated information in a constructive trust for the benefit of the owner from which he stole the information. *Id.* (citing *Cox v. Schnerr*, 156 P. 509, 513 (Cal. 1916); RESTATEMENT OF TORTS § 757 & cmt. b (1939)).

fraud in violation of Rule 10b-5). We need not reach this question because of our holding that Cherif breached a fiduciary duty owed to First Chicago.<sup>217</sup>

Accordingly, given courts' expansion of the misappropriation theory from a narrow version in *O'Hagan* to the endorsement of the broader liability in Rule 10b5-2, *Rocklage's* removal of the fiduciary requirement, and the reinvigoration of the version of the misappropriation theory originally outlined in the *Chiarella* dissent, one is left with the inescapable conclusion that mere thieves are liable for insider trading under Rule 10b-5.<sup>218</sup>

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217. *Cherif*, 933 F.2d at 412 n.6 (citations omitted).

218. The risk of this application of the parity-of-information theory, applying liability for trading based upon improperly obtained confidential information, could open analysts up to liability because of their desire to use their superior knowledge of the market to seek out and put to use information the public does not already know. The Supreme Court so intimated in *Dirks v. SEC*:

Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information," and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally.

463 U.S. 646, 658-59 (1983) (footnotes omitted) (citation omitted). But, this concern is misplaced, because the theory of liability implicit in this concern is not the parity-of-access to information theory, but the parity-of-information theory. The parity-of-information theory, unlike the parity-of-access to information theory, requires all market participants to have the same information, rather than just the ability to have the same information. See *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting) (suggesting that an obligation to disclose arises when an informational advantage is gained by unlawful means). Of course, the parity-of-information theory, while intuitively appealing, is, upon any reflection, untenable—it would require those who invest resources and ability to better understand the market to share that legally obtained knowledge with all market participants before trading on that information. Such a model of behavior is wholly inconsistent with a capitalist economy because it undermines any incentive (i.e., reward) for effort. "[T]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors." *Dirks*, 463 U.S. at 658 n.17.

Some have said that attempting to limit market analysts' use of insider information while still allowing them to make their recommendations is akin to participating in "a fencing match conducted on a tightrope." LANGEVOORT, *supra* note 122, § 11.2 (quotation omitted). For more information on the Court's favorable view of analysts' use of insider information in *Chiarella* and *Dirks*, see Wei Zhang, *Wall Street Analysts: A Conflicted Role in the Marketplace*, 25 QUINNIPIAC L. REV. 573, 587 (2007). See also Barry, *supra* note 41, at 1387-90 (discussing a purpose test for outsider trading and the role of broker advisors).

## IV. LEGISLATION

Some may argue that a judicial application of Rule 10b-5 to mere thieves exceeds the role of the courts. In fact, some already propound that the judicial creation and expansion of the misappropriation theory impermissibly enlarges the language and purpose of the Securities and Exchange Act in the first place.<sup>219</sup>

Rather than allowing courts to be criticized for legislating from the bench, the SEC could revise its own 10b-5 regulations. The SEC could accomplish this in three ways: First, the SEC could promulgate another rule that specifically covers insider trading liability as it relates to illegally obtained information, as it did in promulgating Rule 14e-3<sup>220</sup> after *Chiarella*.<sup>221</sup> Second, the SEC could specify the parameters

See generally J. Scott Colesanti, *Bouncing the Tightrope: The S.E.C. Attacks Selective Disclosure, But Provides Little Stability for Analysis*, 25 S. ILL. U. L.J. 1, 4 (2000) (describing judicial and legislative efforts in the 1990s to relieve market analysts from the burden of Rule 10b-5).

219. Professor J. Dormer Stephen III elucidates this position:

In law, the moment of temptation is the moment of choice, when a judge realizes that in the case before him his strongly held view of justice, his political and moral imperative, is not embodied in a statute or in any provision of the Constitution. He must then choose between his version of justice and abiding by the American form of government. Yet the desire to do justice, whose nature seems to him obvious, is compelling, while the concept of constitutional process is abstract, rather arid, and the abstinence it counsels unsatisfying. To give in to temptation, this one time, solves an urgent human problem, and a faint crack appears in the American foundation. A judge has begun to rule where a legislator should.

Stephen, *supra* note 18, at 326 (quoting ROBERT H. BORK, *THE TEMPTING OF AMERICA: THE POLITICAL SEDUCTION OF THE LAW* 1 (1990)). Professor Saikrishna Prakash provided another description:

Indeed, the SEC's dysfunctional regulatory strategy brings to mind unpleasant images of Cinderella's stepsisters who each chopped off portions of a foot in order to stuff the foot into Cinderella's shoe. By force, dogged persistence, and mangling, the shoe can be made to fit in rough measure, but it is hardly a pretty sight.

Prakash, *supra* note 121, at 1498. One commentator even went so far as to present the issue as an all-or-nothing ultimatum—either absolute liability applies or no misappropriation theory applies. Willis W. Hagan II, *Insider Trading Under Rule 10b-5: The Theoretical Bases for Liability*, 44 BUS. LAW. 13, 33 (1988).

220. 17 C.F.R. § 240.14e-3 (2005):

Transactions in securities on the basis of material, nonpublic information in the context of tender offers.

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

(1) The offering person,

(2) The issuer of the securities sought or to be sought by such tender offer, or

of the prohibition and better define the wrongdoing so as to relieve

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

(b) A person other than a natural person shall not violate paragraph (a) of this section if such person shows that:

(1) The individual(s) making the investment decision on behalf of such person to purchase or sell any security described in paragraph (a) of this section or to cause any such security to be purchased or sold by or on behalf of others did not know the material, nonpublic information; and

(2) Such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate paragraph (a) of this section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase and sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

....

(d)(1) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices within the meaning of section 14(e) of the Act, it shall be unlawful for any person described in paragraph (d)(2) of this section to communicate material, nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of this section *except* that this paragraph shall not apply to a communication made in good faith,

(i) To the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer;

(ii) To the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer; or

(iii) To any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

(2) The persons referred to in paragraph (d)(1) of this section are:

(i) The offering person or its officers, directors, partners, employees or advisors;

(ii) The issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;

(iii) Anyone acting on behalf of the persons in paragraph (d)(2)(i) of this section or the issuer or persons in paragraph (d)(2)(ii) of this section; and

(iv) Any person in possession of material information relating to a tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from any of the above.

221. See Lawrence A. Rosenbloom, Note, *Is It Inside or Out?—A Proposal to Clarify the Misappropriation Theory of Unlawful Trading*, 18 CARDOZO L. REV. 867, 902 & n.231 (1996) (suggesting that the SEC promulgate a prophylactic prohibition against "trading on misappropriated information that causes a direct and imminent harm to the marketplace," similar to Rule 14e-3).

the courts from the burden of making case-by-case determinations.<sup>222</sup> Third, the SEC could establish a general parity-of-access rule and carve out exceptions as necessary.<sup>223</sup>

These options will all fail, of course, if courts find that they fall outside the scope of the SEC's enabling legislation. Thus, while SEC rule-making would increase the ability and the likelihood that courts will explicitly adopt insider trading liability for mere thieves, this resolution will remain unsatisfying to those concerned about the broad role that the judiciary has taken in establishing and defining insider trading liability.<sup>224</sup>

Alternatively, Congress could amend Section 10(b).<sup>225</sup> Moreover, given Section 10(b)'s ambiguity and unpredictability—and the resulting circuit splits—as the judiciary traversed the tortuous path of interpreting insider trading regulations, legislative action could set more definite contours of the Rule's liability.<sup>226</sup>

Notwithstanding that the judiciary has essentially created the law for Rule 10b-5—or perhaps because of it—no single definition of insider trading exists.<sup>227</sup> In 1987, some members of Congress, possibly

222. See Painter et al., *supra* note 16, at 218–20 (emphasizing the need for the SEC to define the boundaries of insider trading, and recommending that Congress enact a definition if the SEC fails to do so).

223. See *id.* at 221 (“For instance, Congress could establish a pre-*United States v. Chiarella* equality of access approach, even for outsiders, and then carve out exceptions, if necessary, for securities analysts and perhaps others who are perceived to benefit securities markets through their use of nonpublic information.”).

224. See *supra* note 219 and accompanying text.

225. See *supra* notes 222–223 and accompanying text.

226. One United States Senator seeking to enact new insider trading legislation emphasized this point:

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

Painter et al., *supra* note 16, at 202 (citing 133 CONG. REC. 16,393 (1987) (statement of Sen. D’Amato)). Justice Rehnquist has stated that Rule 10b-5 is a “judicial oak” that grew from a “legislative acorn.” *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975).

227. Indeed, *Black’s Law Dictionary* offers the following illustration of the difficulty in defining “insider trading” under the law:

“What is insider trading?” The term is probably best defined, to the extent any definition is adequate, as “the purchase or sale of securities on the basis of material, non-public information.” What counts as “non-public information”? What non-public information can be deemed “material”? When is a trader who is in possession of material, non-public information trading “on the basis of” that information? Must the information be about the company whose securities are being purchased or sold? What characteristics establish “insider” status sufficient to

seeking to reverse the judiciary's encroachment on the legislature's traditional function, attempted to codify a definition of insider trading as part of the Insider Trading Proscriptions Act of 1987. The act stated that "information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal, or other relationship of trust and confidence."<sup>228</sup> This definition would encompass the activities of mere thieves.

The SEC, however, fearing that this definition might constrain its enforcement abilities, objected and instead proposed the following even broader definition:<sup>229</sup>

Trading while in possession of material, non-public information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation or any other breach of a fiduciary duty, breach of any personal or other relationship of trust and confidence, or breach of any contractual or employment relationship.<sup>230</sup>

Of course, the SEC's definition would have also imposed liability on mere thieves. However, no congressional consensus developed on a definition and certain members of Congress worried about the unintended effects of such a codification.<sup>231</sup> Accordingly, Congress did

warrant legal proscriptions of trading? These are all questions that are derived from the definition of insider trading just offered . . . .

BLACK'S LAW DICTIONARY 811 (8th ed. 2004) (quoting EDWARD FLETCHER, *MATERIALS ON THE LAW OF INSIDER TRADING* 3 (1991)). One commentator has suggested that the lack of a clear legislative definition of insider trading gives offenders justification to disclaim responsibility by denying awareness that their conduct was criminal. See SZOCKY, *supra* note 16, at 108–11.

228. Karmel, *Outsider Trading*, *supra* note 41, at 100.

229. *Id.*

230. *Id.*

231. *See id.* (noting that Congress delayed codifying a definition of insider trading because of controversy surrounding proposed language). Such laws potentially affect wealthy campaign contributors, and are perhaps subject to more legislative reticence as a consequence. See Bernie DeGroat, *Corporate Political Donations Make Millions for Shareholders*, THE UNIVERSITY RECORD ONLINE (Univ. of Michigan), Jan. 18, 2007, [http://www.umich.edu/~urecord/0607/Jan22\\_07/12.shtml](http://www.umich.edu/~urecord/0607/Jan22_07/12.shtml) (providing data on corporate contributions to political campaigns and suggesting that such contributions affect the legislation process). Publicly traded firms contribute, on average, nearly \$65,000 to 56 Congressional candidates over every two-year election cycle, comprising roughly eleven percent of total campaign financing, and Huseyin Gulen, Professor of Finance at Virginia Tech University, commented that "[r]emarkably, there is a positive and significant relationship between contributions [made by publicly traded companies] and future profitability [of those companies]." *Id.*

not include any definition whatsoever in the statute.<sup>232</sup> No definition has been codified since.<sup>233</sup> Instead, Congress has—essentially through institutional paralysis—effectively acceded to the judiciary’s development of this area of the law.<sup>234</sup>

Almost every other country that prohibits insider trading uses statutes that specifically define the relevant terms. Moreover, “[t]he European Union revised their insider trading laws to make it clear that any gaining of inside information by criminal activity would be a violation of insider trading laws.”<sup>235</sup> Only the United States refuses to legislatively define its terms, allowing the judiciary significant discretion in developing the prohibition against insider trading.<sup>236</sup> While

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232. Steve Thel, *Section 20(d) of the Securities Exchange Act: Congress, the Supreme Court, the SEC, and the Process of Defining Insider Trading*, 69 N.C. L. REV. 1261, 1262 (1991); see also H.R. REP. NO. 100-910, at 11 (1988), cited in CHARLES O’KELLEY & ROBERT THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 1037 (4th ed. 2003). The report states:

While cognizant of the importance of providing clear guidelines for behavior which may be subject to stiff criminal and civil penalties, the Committee nevertheless declined to include a statutory definition in this bill for several reasons. First, the Committee believed that the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and that a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law. Second, the Committee did not believe that the lack of consensus over the proper delineation of an insider trading definition should impede progress on the needed enforcement reforms encompassed within this legislation. Accordingly, the Committee does not intend to alter the substantive law with respect to insider trading with this legislation. The legal principles governing insider trading cases are well-established and widely-known.

*Id.*

233. Some suggest that this outcome is a positive result: “Like a gardener caring for a rose bush, the courts have allowed the definition of insider trading to blossom, often pruning it back when it becomes overgrown, continually reshaping it.” SZOCKYJ, *supra* note 16, at 54. But see Painter et al., *supra* note 16, at 228 (stating that if the government recognizes that all of this confusion “stems from the way courts have interpreted a statutory provision that does not even mention, much less define, insider trading or misappropriation,” then the government should recognize the need to amend the law governing insider trading).

234. See H.R. REP. NO. 100-910, at 11 (1988), cited in O’KELLEY & THOMPSON, *supra* note 232, at 1037 (stating that Congress has declined to codify a definition for insider trading because members believed court-drawn parameters were sufficient).

235. Floyd Norris, *Is Theft Deception? It Matters*, N.Y. TIMES, Feb. 15, 2008, at C1 (quoting Georgetown Law Professor, and expert on insider trading, Donald Langevoort).

236. See Marc I. Steinberg, *Insider Trading Regulation—A Comparative Analysis*, 37 INT’L LAW. 153, 162–63 (2003). Steinberg comments on the discrepancy as follows:

Unlike the United States, key terms comprising the insider trading offense are delineated by statute. For example, . . . [u]nder German law, an “insider fact” is “knowledge of a fact not publicly known relating to one or more issuers of insider securities or to insider securities and which fact is capable of substantially influencing the price of the insider securities in the event of it becoming publicly known.” Other nations likewise define, pursuant to statute, the elements of privileged information or an inside fact. Additional key concepts are also set forth by

legislation would guarantee the application of Rule 10b-5 to mere thieves,<sup>237</sup> future legislative action seems unlikely.

## V. CONCLUSION

Securities markets face a new threat never before seen. Now for the first time thieves can use relatively unsophisticated technology to conduct corporate espionage and, thereafter, trade stock based on their stolen secrets. Indeed, the SEC's recent confrontation with this phenomenon only foreshadows its likely greater incidence in the near future. Unfortunately, the largely court-created securities jurisprudence has failed to address the scope of liability for this growing problem due to its novelty.<sup>238</sup>

In this Article, I set forth a jurisprudential analysis under which mere thieves who trade on stolen confidential information are liable under Rule 10b-5 pursuant to insider trading doctrine.<sup>239</sup> This theory is significant for two reasons. The first is purely practical: insider trading liability offers much greater damages than 10b-5 liability for simple fraud.<sup>240</sup> The second is philosophical: the theory laid out in this Article is not only supported by case law, it is sound policy. Full application of Rule 10b-5 to mere thieves would properly order penalties for wrongdoers. The foundational premise of the theory is that the misconduct committed by thieves is more culpable than misconduct committed by traditional insiders, because insiders obtain their information lawfully but use it unlawfully, whereas the thief obtains his in-

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statute, including, for example, those persons who are defined as insiders, enjoying a "special relationship" with the enterprise or having "access" to nonpublic information.

*Id.*; see also Painter et al., *supra* note 16, at 211-12 (observing that the United States is unique in prohibiting insider trading using a common law approach). The lack of a specific definition has clearly led to confusion in the general public, so much so that some see the seriousness of insider trading as "loosely analogous to jaywalking." SZOCKYJ, *supra* note 16, at 110-11.

237. See *United States v. O'Hagan*, 521 U.S. 642, 679 (1997) (Scalia, J., concurring in part and dissenting in part) (reasoning that the statutory language of Section 10(b) "must be construed to require the manipulation or deception of a party to a securities transaction"); Karmel, *Outsider Trading*, *supra* note 41, at 108 (criticizing Rule 10b-5 as being "impermissibly vague for a criminal statute" and suggesting that the rule should be limited so that it applies to mere thieves); Painter et al., *supra* note 16, at 196-200 (describing the limitations of the Court's role in defining criminal conduct and the resulting ambiguities concerning the scope of culpability for insider trading); see also SZOCKYJ, *supra* note 16, at 108 (suggesting that the lack of a legislative definition of insider trading hampers the prosecution of insiders).

238. See *supra* Part II.B.

239. See *supra* Part III.

240. See *supra* Part II.A.-B.

formation unlawfully *and* uses it unlawfully. The thief's wrongdoing is at least as significant as the insider's, if not more so, thus, thief's punishment should reflect this culpability.