

The SEC'S Criminal Rulemaking in Rule 10b5-2: Incarceration Should be Made of Sterner Stuff

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I. INTRODUCTION

Concepts of investing money, trading stocks, and following financial markets have never been more relevant to the lives of everyday Americans. But as investors have become more sophisticated in their stock market transactions, those entrusted to oversee and regulate investor activity—Congress, the courts, and government agencies—have failed to keep pace. The most recent failure in this area may be the inability of the Securities Exchange Commission (SEC), the federal agency dedicated to preserving the integrity of the markets and promoting investor confidence, to clearly define the reach of criminal liability for insider trading under what has become known as the Misappropriation Theory. This lingering enigma demands attention if investor interest and confidence is to remain high. The following hypothetical illustrates the shortcomings and potential pitfalls of the Theory:

Joe works for a travel agency that does not have a confidentiality policy regarding the identity of its clients.¹ An airliner crashes leaving no survivors. Joe remembers that he ticketed IBM's chief executive officer on this flight. Joe realizes that IBM's stock price may drop because of the officer's death. Joe tells Mr. Big, the sole proprietor of the travel agency. Mr. Big says, "Well, what are you waiting for? Go trade!" So, before the list of passengers on that flight becomes public, Joe makes one million dollars in less than twenty-four hours, with zero invested capital, by selling IBM stock short.

Now, suppose that Jane, a stockbroker, just happened to be at the same airport, traveling on business, while passengers boarded the doomed airliner. The company Jane works for has a strict confidentiality policy that prohibits trading on the basis of information obtained

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I dedicate this article to my parents, Quang and Anh Hang, who endured tremendous adversity in moving their life and family to America. Thank you, Papa and Mama Hang. Your incomparable work ethic and enormous, personal sacrifices have provided me numerous opportunities for personal, academic, and professional growth.

1. Although a travel agency may have a policy prohibiting any employee from discussing a client's travel plans, it seems unlikely that a travel agency would specifically prohibit employees from using information about the identity of its clients to trade on stocks.

within the scope of employment, or in any way related to time spent working for the brokerage firm.² Jane recognizes one of the passengers as the chief executive officer of IBM. After she discovers that the airliner crashed, Jane sells her IBM shares and those of her customers, and reaps substantial profits.

Under the current law of insider trading, Jane could be prosecuted under the Misappropriation Theory and sentenced to prison, but not Joe.³ It is difficult to make sense of this outcome, just as it is to discern the broader policy basis for the Misappropriation Theory. Whether Jane or Joe is punished under the Theory, trading on material nonpublic information has occurred. In either scenario, the person on the other side of the securities transaction would still feel there is not a level playing field in the securities market, and the integrity and fairness of the securities market is still compromised. As such, the Misappropriation Theory does nothing for the confidence of a particular investor; liability is untethered to conduct harming investor confidence. Nonetheless, 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.

The anomalous result of prosecuting Jane, but not Joe, is one of many examples demonstrating the confusion of insider trading law.⁴ Although a fiduciary duty analysis is at the heart of the Misappropriation Theory,⁵ appellate courts, including the United States Supreme Court, have failed to define what kinds of relationships trigger liability for insider trading based on the Theory.

This definitional vacuum has in turn led to tremendous confusion about the viability of the Misappropriation Theory as a standard of criminal liability.⁶ Congress, through its inaction, has done nothing but add to this ambiguity.⁷ Recently, the SEC promulgated Rule

2. The 1934 Act requires companies employing brokers to create policies "to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." 15 U.S.C. § 78o(f) (1998).

3. Compare this hypothetical with Mr. Beeson's travel agent/portfolio manager scenario. See generally 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, 1078-79 (1996).

4. See Richard W. Painter et al., *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 188 (1998).

5. Steven A. Ramirez & Christopher M. Gilbert, *The Misappropriation Theory of Insider Trading Under United States v. O'Hagan: Why Its Bark Is Worse Than Its Bite*, 26 SEC. REG. L.J. 162, 189 (1998).

6. Painter et al., *supra* note 4, at 188.

7. See *id.* at 203. "Congress has taken no action since 1934 that should cause [the U.S. Supreme Court] to alter its interpretation of §10(b)." Brief of Amici Curiae Law Professors and Counsel in Support of Respondent at 3, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 143793). "[O]ver the last ten years, as the Commission has begun more vigorously to enforce insider trading prohibitions, including by criminal referral, and as the penalties for such trading have been enhanced, many people have called on Congress to specify when trading on material nonpublic information is illegal, so far without success." *Id.* at 28.

10b5-2 setting forth three situations in which a person owes a duty of trust or confidence under the Misappropriation Theory.⁸ Although this rule is a move in the right direction, it is still woefully inadequate as a basis for criminal prosecution.

Despite the chaos surrounding the Misappropriation Theory, insider trading continues to plague the securities market.⁹ The focus of insider trading prosecutions has shifted to lower level corporate fiduciaries and their friends and families.¹⁰ These individuals have become the target of the Misappropriation Theory.¹¹ Prosecutions based on such a muddled form of liability are indeed problematic. Further, when a suspected insider trader faces incarceration based on such a confusing theory,¹² it invokes due process concerns and the argument for clarity becomes even more compelling.¹³

8. 17 C.F.R. § 240.10b5-2 (2001). The rule outlines three situations:

- (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 reasonably 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.

9. William R. McLucas & Alma M. Angotti, *Insider Trading: Is It Back or Did It Ever Really Go Away?*, 10 LAW & BUS. INSIGHTS 2, 6 (1995). The SEC has been bringing approximately forty insider trading cases a year. Phyllis Diamond, *McLucas Hails O'Hagan Ruling, But Says Issues Over Reach of Theory Remain*, 29 SEC. REG. & L. REP. (BNA) 1097 (1997). In almost half of these cases, the SEC applied the Misappropriation Theory. *Id.* In 1996, the National Association of Securities Dealers (NASD) referred 121 cases of potential insider trading violations to the SEC. Richard Reuben, *The Insider Story*, 83 A.B.A. J. 44 (1997). In just the first quarter of 1997, the NASD made over fifty referrals to the SEC. *Id.*

10. McLucas & Angotti, *supra* note 9, at 2.

11. *See, e.g.*, *United States v. Willis*, 778 F. Supp. 205 (S.D.N.Y. 1991) (affirming the conviction of a psychiatrist who sold Bank of America Corporation shares based on information he received from his patient, the wife of the company's president, that her husband sought to become the company's chief executive officer); *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985) (affirming conviction of father, an ABC corporation board member, who frequently discussed company business with his son, who then used information from these conversations to trade on ABC's stocks); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991) (affirming conviction of a former bank employee who forged signatures to obtain security card and broke into the company's files to obtain confidential information).

12. 15 U.S.C. § 78ff(a)(1998) provides in pertinent part:

Any person who willfully violates any provision of this title . . . or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title . . . shall upon conviction be fined not more than \$1,000,000, or imprisoned not more than 10 years, or both.

13. "Flexible interpretations of regulatory statutes that incrementally expand a statute beyond its original purposes, although perhaps defensible in occasional and highly unusual civil enforcement contexts, are impermissible in criminal prosecutions." Brief for Respondent James Herman O'Hagan at 33 *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 143801).

Many commentators have written about the ambiguities of the Misappropriation Theory, highlighting its many shortcomings.¹⁴ Some have argued the courts have failed to identify the legal basis for the fiduciary duty analysis.¹⁵ Others have argued that either Congress or the SEC could define “when it is illegal for corporate outsiders to trade while in possession of nonpublic information.”¹⁶ This Note posits that the SEC should articulate, in detail, the parameters of the fiduciary duties that give rise to Rule 10b-5 liability under the Misappropriation Theory. The federal circuits, the U.S. Supreme Court, and Congress have certainly failed to do so.

In creating Rule 10b5-2, the SEC made a half-hearted and half-baked effort in responding to the criticisms of the Misappropriation Theory. This exercise in uninspired rulemaking was far too little too late, leaving every major shortcoming of the Theory intact. This new rule cannot be applied criminally to prosecute insider trading violations unless the SEC concedes that liability rests on state-law defined fiduciary duties.¹⁷ If the SEC is unwilling to do so, it must specifically

14. See, e.g., Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1190 (1995) (criticizing the Theory's failure to address what precise fiduciary duty is at issue and whether the source of that duty is state or federal law); Beeson, *supra* note 3, at 1084-85 (arguing that the Misappropriation Theory is an ineffective weapon against insider trading and that the SEC should replace it with a definition of those people who are prohibited from trading on the basis of material nonpublic information); Michael P. Kenny & Teresa D. Thebaut, *Misguided Statutory Construction To Cover the Corporate Universe: The Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 143 (1995) (criticizing the Theory as a radical departure from the U.S. Supreme Court's precedent concerning the scope of Rule 10b liability); Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1496-97 (1999) (arguing that the O'Hagan Court interpreted Rule 10b-5 whereby liability attaches whenever a securities trade triggers deception); Carol B. Swanson, *Reinventing Insider Trading: The Supreme Court Misappropriates the Misappropriation Theory*, 32 WAKE FOREST L. REV. 1157, 1160 (1997) (arguing that the U.S. Supreme Court's adoption of the Misappropriation Theory was a lost opportunity that left old questions unanswered, created new issues, and furthered policy rationales that were inconsistent with its holding); Micah A. Acoba, Note, *Insider Trading Jurisprudence After United States v. O'Hagan: A Restatement (Second) of Torts § 551(2) Perspective*, 84 CORNELL L. REV. 1356, 1360 (1999) (examining insider trading in the context of section 551(2) of the Second Restatement of Torts and arguing that the Theory is problematic in the areas of Rule 10b requirements, practical application, and consistency with prior case law); James L. Kelly, Comment, *The Unpredictable Net: United States v. O'Hagan; The Misappropriation Theory Upsets Investor Confidence By Catching More Than the Plain Statutory Language and Established Precedent*, 49 SYRACUSE L. REV. 1067, 1070 (1999) (arguing that the Theory produces ex post facto and vagueness concerns and that policy considerations do not favor its adoption); Sean P. Leuba, Note, *The Fourth Circuit Breaks Ranks in United States v. Bryan: Finally, a Repudiation of the Misappropriation Theory*, 53 WASH. & LEE L. REV. 1143, 1208-09 (1996) (arguing the Theory is a pretext for enforcing equal opportunity in information and suggesting the Theory should be eliminated); Bryan S. Schultz, Casenote, *Feigning Fidelity to Section 10(B): Insider Trading After United States v. O'Hagan*, 117 S. Ct. 2199, 66 U. CIN. L. REV. 1411, 1414 (1998) (arguing the Theory deprives insider trading of certainty and predictability).

15. See, e.g., Ramirez & Gilbert, *supra* note 5, at 188-89.

16. See, e.g., Painter et al., *supra* note 4, at 158-59.

17. Even if state law served as the source for defining fiduciary duties under the Misappropriation Theory, choice-of-law problems remain. Consider Professor Ramirez and Mr. Gilbert's choice-of-law quagmire: “[A] father who is an agent of a Delaware corporation, located in Illinois, ‘inadvertently’ discloses ‘hot’ information to his son in Missouri, and the son trades on the basis of the tip through a broker in New York, and all three are indicted for violation of Rule 10b-5” Ramirez & Gilbert, *supra* note 5, at 198.

define the fiduciary duties that will give rise to liability under the Misappropriation Theory for the Theory to have any hope of viability.

Before examining the confusion surrounding the Misappropriation Theory, it is necessary to discuss how the Theory developed and how the U.S. Supreme Court, the federal circuits, and Congress have treated it. This Note then examines the Theory's criticisms, focusing mainly on the problems with relying on a fiduciary duty analysis. Finally, this Note concludes by articulating why Rule 10b5-2 cannot be applied criminally, arguing why the SEC needs to define fiduciary duties, and suggesting what can be done.

II. BACKGROUND

A. *What Is Insider Trading?*

"Insider trading is a term of art generally meaning, or referring to, unlawful trading by someone, whether or not the person is a true corporate insider, possessing material, nonpublic information about publicly traded securities."¹⁸ Information is "material" if it would be important for an investor to have in deciding whether to sell or purchase a security.¹⁹ Although securities laws do not define insider trading, it is prohibited by § 10(b), § 14(e), and § 17(a) of the Securities Exchange Act of 1934 (1934 Act).²⁰

There are various reasons for criminalizing insider trading; they all center on the policies of promoting investor confidence and the fundamental fairness to market participants.²¹ Investor confidence has been cited as one of the principal goals of the 1934 Act.²² The integrity of the securities market depends on investor confidence.²³ Without investor confidence, "many [investors] would decline to participate in the markets at all, for they would know that they were playing a game in which the dice might, at any time, be loaded."²⁴ It has

18. Symposium, *Insider Trading: Law, Policy, and Theory After O'Hagan*, 20 CARDOZO L. REV. 7, 9 (1998).

19. H.R. REP. NO. 100-910, at 7 (1988), reprinted as 1988 U.S.C.C.A.N. 6043 [hereinafter H.R. REP. NO. 100-910].

20. *Id.*

21. Primarily, the 1934 Act aimed 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, . . . and to provide, to the maximum degree practicable, markets that are open and orderly." H.R. CONF. REP. NO. 94-229, at 91-92 (1975).

22. See 15 U.S.C. § 78(b) (1999). "[I]nvestor confidence was so low before the enactment of the federal securities laws that the issuance of new corporate securities had plummeted from \$9.4 billion in 1929 to \$380 million in 1933." Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious As Well As the Frivolous*, 40 WM. & MARY L. REV. 1055, 1066 n.35 (1999)(citing I LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 216 (3d ed. 1998)). "This is the reason lawmakers pursued aggressive policies to restore confidence, including enacting the federal securities laws." *Id.*

23. See *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (quoting 45 Fed. Reg. 60,412 (1980)).

24. Brief for the United States, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 86306).

been argued that insider trading negatively affects investor confidence in two ways.²⁵ First, a transaction with an insider trader results in an investor trading at the wrong price.²⁶ In other words, the price at which an investor trades does not reflect the undisclosed information.²⁷ Second, insider trading induces an investor to make an ill-advised transaction.²⁸

Besides the negative effect on investor confidence, it is fundamentally unfair to permit insider trading.²⁹ Insider traders monopolize the information they obtain, thereby robbing investors who could not benefit from it.³⁰ These investors expect that trading securities will involve prices that represent public information about the issuer of the information and do not bargain for an uneven playing field.³¹ As such, when insider trading occurs, it hurts investor confidence.³² It also deters small investors from participating because they would feel the playing field is not level.³³

B. *Enforcement of Insider Trading Prior to Rule 10b-5*

Prior to the adoption of Rule 10b-5 in 1934, there was inadequate relief available to shareholders when insider trading occurred.³⁴ This was because state common law held that corporate insiders owed a fiduciary duty only to the corporate entity itself.³⁵ As such, shareholders had no general cause of action for insider trading unless misrepresentation could be proven.³⁶ Insiders who bought stocks through an exchange did not have to disclose material information to sellers.³⁷ Likewise, insiders who sold their corporation's securities owed no duty to the corporation's shareholders.³⁸

25. Bainbridge, *supra* note 14, at 1239.

26. *Id.*

27. *Id.*

28. *Id.*

29. Beeson, *supra* note 3, at 1097.

30. *Id.* "Insider trading damages the legitimacy of the capital market and diminishes the public's faith. The investing public has a legitimate expectation that the prices of actively traded securities reflect publicly available information about the issuer of such securities." H.R. REP. NO. 100-910, *supra* note 19, at 8.

31. H.R. REP. NO. 100-910, *supra* note 19, at 8. "The average investor must be assured that the securities marketplace is above all else a fair and level playing field, and not a steep, rigged incline." 145 CONG. REC. E 3078, 3079 (daily ed. Sept. 23, 1988) (statement of Rep. Markey).

32. H.R. REP. NO. 100-910, *supra* note 19, at 8.

33. Timothy M. Wong, *United States v. O'Hagan: SEC prevails on Misappropriation Theory, Yet May Now Face Heightened Standard of Proof for Securities Insider Trading*, 32 U.S.F. L. REV. 841, 843 (1998).

34. Michael J. Voves, *United States v. O'Hagan: Improperly Incorporating Common Law Fiduciary Obligations into 14(e) of the Securities Exchange Act*, 81 MINN. L. REV. 1015, 1021 (1997).

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

C. Rule 10b-5 and Its Two Theories of Liability

Congress passed the 1934 Act in response to the enormous investor losses of the 1929 stock market crash.³⁹ After various stock exchanges unsuccessfully tried to regulate fraud, Congress stepped in and began investigating stock market practices.⁴⁰ These investigations concluded that the improper use of inside information was the primary cause for the perpetration of fraud upon investors.⁴¹

Under the 1934 Act, Congress created the SEC to tackle problems with securities law and regulate the securities markets.⁴² Insider trading was one of these problems and has become the focus of the SEC's enforcement power.⁴³ Pursuant to its rulemaking authority delegated by Congress, the SEC created Rule 10b and Rule 10b-5 to combat insider trading.⁴⁴ Both rules are the foundation for the Misappropriation Theory.⁴⁵ Rule 10b-5 was designed to be a broad, flexible, anti-fraud provision that had almost nothing to do with insider trading.⁴⁶ The hallmark of this provision is that there be "deception in connection with the purchase or sale of a security."⁴⁷ Even though Rule 10b is a catchall provision, "what it catches must be fraud."⁴⁸

Two theories of liability emerged from Rule 10b-5.⁴⁹ One of these theories is known as the Traditional or Classical Theory.⁵⁰ The

39. Theodore McCullough, *United States v. O'Hagan: Defining the Limits of Fraud and Deceptive Pretext Under Rule 10b-5*, 22 SEATTLE U. L. REV. 311, 314 (1998).

40. *Id.*

41. *Id.*

42. Lacey S. Calhoun, *Moving Toward a Clearer Definition of Insider Trading: Why Adoption of the Possession Standard Protects Investors*, 32 U. MICH. J.L. REFORM 1119 (1999). See also 15 U.S.C. § 78o(f) (1998).

43. *Id.* at 1119-20.

44. *Id.* Rule 10b states in pertinent part:

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

15 U.S.C. § 78j (1999).

45. 17 C.F.R. § 240.10b-5. Rule 10b makes it unlawful to engage in manipulative and deceptive acts and practices in connection with a sale of securities. Rule 10b specifically authorizes the SEC to promulgate rules defining such prohibited conduct. Rule 10b-5 is one of these rules.

46. Schultz, *supra* note 14, at 1416. Rule 10b-5 states in pertinent part:

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

(a) To employ any device, scheme, or artifice to defraud [or]

(b) To make any untrue statement of 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."

17 C.F.R. § 240.10b-5 (2001).

47. Ramirez & Gilbert, *supra* note 5, at 164.

48. Chiarella v. *United States*, 445 U.S. 222, 235 (1980).

49. McCullough, *supra* note 39, at 316.

50. *Id.*

Classical Theory imposes liability on corporate insiders who obtain material nonpublic information as a result of their positions with the corporation and use it to trade in their corporation's securities.⁵¹ This theory of liability is based on the obligation to disclose the inside information or abstain from using it.⁵²

The Misappropriation Theory is the second theory of liability under Rule 10b-5.⁵³ It is a relatively new theory of prosecution for insider trading.⁵⁴ It was created by and mainly developed through the lower federal courts. A person is liable under this theory when he "(1) misappropriates material nonpublic information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock."⁵⁵ Under this theory, Rule 10b-5's requirement of fraud is satisfied because by misappropriating confidential information in breach of a fiduciary duty, the person has defrauded "the principal of the exclusive use of that information."⁵⁶ Likewise, the misappropriation is "in connection with the purchase or sale of [securities]" because the misappropriator uses the information to trade securities.⁵⁷

51. *Id.* Some commentators have even argued that the Misappropriation Theory could subsume the Classical Theory. See, e.g., Ramirez & Gilbert, *supra* note 5, at 195 n.229.

52. McCullough, *supra* note 39, at 317. In *Chiarella*, the Court ruled that this duty to disclose or abstain was not based on the possession of insider information, but came from "a fiduciary or other similar relation of trust and confidence between [the parties to the transaction]." *Chiarella*, 445 U.S. at 228.

53. McCullough, *supra* note 39, at 317. Unlike the Classical Theory, the Misappropriation Theory does not require that a company insider breach a fiduciary duty owed to the company's shareholders. Troy Cichos, *The Misappropriation Theory of Insider Trading: Its Past, Present, and Future*, 18 SEATTLE U. L. REV. 389, 401 (1995). In fact, the Misappropriation Theory targets a situation that the Classical Theory fails to address. Wong, *supra* note 33, at 845. For instance, if an employee of a corporation obtained material nonpublic information about another corporation that his company prepared to take over, he would be considered an outsider of that corporation. *Id.* If this outsider then traded on the shares of that corporation based on this information, the Classical Theory would not outlaw such trading. *Id.*

On the other hand, under the Misappropriation Theory, this outsider could be criminally liable. *Id.* By using the information he gained as an employee of his company to trade securities, he has violated a fiduciary duty to his company, the source from which he obtained the information. *Id.* Although the outsider owes no duty to the corporation in whose shares he traded or its shareholders, he is still could be criminally liable under the Misappropriation Theory. *Id.* Therefore, the Misappropriation Theory expands the enforcement power of the SEC under Rule 10b-5 to cover those persons who are not corporate insiders. *Id.* However, liability under the Misappropriation Theory turns on the duty owed to the source of the information, which may be someone who has no connection whatsoever with the securities market. *Id.* This fiduciary duty analysis has led to considerable ambiguity, causing the Misappropriation Theory to be a vague basis upon which to criminalize insider trading. *Id.* at 846.

54. The Misappropriation Theory first appeared in 1978 before the U.S. Court of Appeals for the Second Circuit in *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978). It was not until 1997 that the U.S. Supreme Court held that the Misappropriation Theory could support criminal liability under Rule 10b-5. *United States v. O'Hagan*, 521 U.S. 642 (1997).

55. *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995).

56. *O'Hagan*, 521 U.S. at 654-55.

57. *Id.*

D. *The Beginnings of the Misappropriation Theory*

The Misappropriation Theory made its Supreme Court debut in *Chiarella v. United States*.⁵⁸ In *Chiarella*, the defendant, Vincent Chiarella, worked for a printing company that generated corporate documents.⁵⁹ Some of the documents concerned mergers, acquisitions, and tender offers.⁶⁰ The company's policy mandated that employees keep information they obtained through employment a secret.⁶¹ Chiarella discovered how to obtain the names of companies that were about to be acquired.⁶² He then used the information to trade on the stocks of these companies.⁶³ Subsequently, Chiarella was convicted of violating Rule 10b-5.⁶⁴

After the U.S. Court of Appeals for the Second Circuit affirmed Chiarella's convictions,⁶⁵ he appealed to the U.S. Supreme Court.⁶⁶ On appeal, the government argued that there was another basis for holding Chiarella liable.⁶⁷ The government claimed that in addition to the duty Chiarella owed his employer, he also breached a duty to the acquiring corporation.⁶⁸ The government further argued that by misappropriating confidential information from his employer, Chiarella committed fraud on both the acquiring corporation and the investors from whom he purchased securities.⁶⁹

Unfortunately, the jury received no instruction on the government's misappropriation argument, and the issue was struck on appeal.⁷⁰ As such, the Court did not consider it.⁷¹ Instead, it reversed Chiarella's convictions.⁷² The Court held that an allegation of nondisclosure was insufficient for a fraud conviction under Rule 10b-5.⁷³ The Court explained that Chiarella had no duty to disclose the information he obtained to the sellers of the target company's securities because he had no relationship with them.⁷⁴ Moreover, Chiarella was

58. *Chiarella*, 588 F.2d 1358 (2d Cir. 1978).

59. *Id.* at 1363.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.* at 1373. The court stated that the securities laws "[c]reated a system providing equal access to the information necessary for reasoned and intelligent investment decisions." *Id.* at 1362. Thus, anyone who used material information not available to the public committed fraud because such information gave that person an advantage over less-informed market participants. *Id.*

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

67. *Id.* at 235.

68. *Id.*

69. *Id.* at 235-36.

70. *Id.*

71. *Id.* at 236.

72. *Id.* at 237.

73. *Id.*

74. *Id.* at 232.

not their agent, fiduciary, or someone in whom they placed their trust and confidence.⁷⁵

Although the majority rejected the government's misappropriation argument, two of the justices discussed it with some approval. For instance, in his concurrence, Justice Stevens stated that the majority did not address whether Chiarella's breach of his duty of silence, "a duty he unquestionably owed to his employer and to his employer's customer—could give rise to criminal liability under Rule 10b-5."⁷⁶ He felt that "[assuming Chiarella] breached a duty to the acquiring companies that had entrusted confidential information to his employers, a legitimate argument could be made that his actions constituted a fraud or a deceit upon those companies in connection with the purchase or sale of any security."⁷⁷

Likewise, in his dissent, Chief Justice Burger also argued that there could be a Misappropriation Theory of liability.⁷⁸ However, he claimed that under Rule 10b-5, liability could be premised on a fiduciary duty to someone other than the source of the information.⁷⁹ Despite the government's failure to present this theory to the jury at trial, the language of Chief Justice Burger and Justice Stevens left open the possibility that insider trading could be illegal based on a breach of a fiduciary duty of trust or confidence.⁸⁰

Although its legitimacy had not yet been decided, lower federal courts continued to uphold insider trading convictions under the Misappropriation Theory.⁸¹ In *United States v. Newman*,⁸² the Second Circuit became the first court to find criminal violations under the Theory.⁸³ In *Newman*, two investment bankers from Morgan Stanley revealed information concerning mergers and acquisitions to the defendant, James Newman, a stock trader.⁸⁴ Morgan Stanley received this information from its corporate clients.⁸⁵ The defendant then gave this information to two other individuals.⁸⁶ The trio used the stolen information to buy stocks of target companies and reap substantial

75. *Id.*

76. *Id.* at 238 (Stevens, J., concurring).

77. *Id.* (Stevens, J. concurring) (internal quotations omitted).

78. *Id.* at 240-41 (Burger, C.J., dissenting).

79. *Id.* at 243 (Burger, C.J., dissenting). In his dissent, Chief Justice Burger argued that the government's theory supported Chiarella's conviction. *Id.* at 239-45 (Burger, C.J., dissenting).

80. *Id.* at 243 (Burger, C.J., dissenting); *United States v. O'Hagan*, 521 U.S. 642, 662 (1997).

81. Wade M. Hall, *Insider Trading Liability: Are We Ready to Leave the Misappropriation Theory?*, 44 KAN. L. REV. 867, 876 (1996).

82. 664 F.2d 12 (2d Cir. 1981).

83. *United States v. Newman*, 664 F.2d 12, 19 (2d Cir. 1981).

84. *Id.* at 15.

85. *Id.*

86. *Id.*

profits.⁸⁷ However, the trial court dismissed the government's indictment.⁸⁸

The Second Circuit reversed the trial court's dismissal.⁸⁹ The court recognized that neither Morgan Stanley nor any of its clients were purchasers or sellers of the target company's securities.⁹⁰ Nonetheless, the court held that the defendant could still be criminally liable under the Misappropriation Theory of Rule 10b-5.⁹¹ The court reasoned that Rule 10b-5 did not specifically require that the proscribed fraud be committed upon the seller or buyer of securities.⁹² The court further explained that the defendant defrauded Morgan Stanley because he took part in a plan to damage the company's reputation.⁹³ Likewise, the defendant defrauded Morgan Stanley's clients.⁹⁴ These clients expected their takeover plans to be driven by market forces, not by the defendant's manipulation of confidential information.⁹⁵ The court apparently felt that Newman had a duty to disclose this information to Morgan Stanley and its clients.⁹⁶ However, in its analysis, the Second Circuit failed to identify the law it used to determine that the defendant had such a duty. Likewise, the court did not explain why Newman even owed a duty to Morgan Stanley or its clients.

Despite its lack of clarity regarding the fiduciary duty analysis, the Second Circuit continued to apply the Misappropriation Theory. In *United States v. Carpenter*,⁹⁷ the court affirmed the conviction of a *Wall Street Journal* columnist who wrote about the market prices of stocks and leaked information to two stockbrokers prior to the column's publication.⁹⁸ The brokers then used this information to trade securities and shared profits with the columnist.⁹⁹

87. *Id.* The indictment charged criminal violations of insider trading stating the defendant "aided, participated in, and facilitated [the Morgan employees] in violating the fiduciary duties of honesty, loyalty, and silence owed directly to Morgan Stanley . . . and [its] clients." *Id.*

88. *Id.* at 14.

89. *Id.* at 19.

90. *Id.* at 17.

91. *Id.* The Second Circuit broadly interpreted Rule 10b-5. However, the court did not discuss the 1934 Act at all. *United States v. Bryan*, 58 F.3d 933, 954 (4th Cir. 1995). The court just adopted the Theory and concluded that the broad language of Rule 10b-5 was consistent with its decision. *Id.*

92. *Newman*, 664 F.2d at 17.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* The *Newman* court was more concerned about the employer's breach of duty to his employer than the fraud committed upon the companies whose shares were traded. *SEC v. Cherif*, 933 F.2d 403, 409 (7th Cir. 1991).

97. 791 F.2d 1024 (2d Cir. 1986).

98. *United States v. Carpenter*, 791 F.2d 1024, 1026-29, 1036 (2d Cir. 1986).

99. *Id.* The columnist claimed his conviction could stand only if it were found that he had a duty to the corporation in which the brokers purchased stocks. *Id.* at 1028-29. Because the government premised liability on a fiduciary duty to the defendant's employer, the source of the information, the defendant argued that the Theory was insufficient for conviction. *Id.*

The Second Circuit reiterated a lower court's view that "trading on the basis of improperly obtained information is fundamentally unfair, and . . . distinctions premised on the source of the information undermine the prophylactic intent of the securities laws."¹⁰⁰ The court also noted that the U.S. Supreme Court supported a flexible interpretation of the securities laws, which were adopted to fight fraud.¹⁰¹ The Second Circuit's reasoning focused on the language of Rule 10b-5, which prohibits "any act, practice, or course of business which operates as a fraud or deceit upon any person."¹⁰² The court also noted that the purpose and policy of Rule 10b-5 was to prevent all fraudulent conduct.¹⁰³ As such, the application of the Misappropriation Theory to impose criminal liability was appropriate in this case.¹⁰⁴

The *Carpenter* defendant appealed to the U.S. Supreme Court.¹⁰⁵ The Court did recognize that the *Wall Street Journal* had an exclusive right to the use of its confidential information.¹⁰⁶ The Court also stated that the defendant's misappropriation of this information constituted fraud.¹⁰⁷ However, the Court split evenly over the application of the Misappropriation Theory, which effectively upheld the defendant's convictions.¹⁰⁸ As such, it was difficult to determine if the Court rejected the Theory entirely or merely rejected its application as applied to the facts.¹⁰⁹ The Court's failure to express any opinion regarding the Second Circuit's adoption of the Theory allowed other federal circuits to expand the scope of Rule 10b-5 based on an undefined fiduciary duty analysis.¹¹⁰

Following the Supreme Court's lack of discussion concerning the Misappropriation Theory in *Carpenter*, Congress added to the confu-

100. *Id.* at 1029 (quoting *SEC v. Musella*, 578 F. Supp. 425, 438 (S.D.N.Y. 1984)).

101. *Id.*

102. *Id.* at 1030 (quoting 17 C.F.R. § 240.10b-5) (emphasis omitted).

103. *Id.*

104. *Id.* The Second Circuit's decision in *Carpenter* laid the groundwork for future Misappropriation Theory cases. In fact, four other federal circuits have joined the Second Circuit in adopting the Misappropriation Theory. *See generally* *SEC v. Peters*, 915 F.2d 1162 (10th Cir. 1992); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818 (3d Cir. 1985). Basically, under the Misappropriation Theory, anyone, even someone who traded just one security, could face criminal liability under Rule 10b-5. Cichos, *supra* note 53, at 401.

Likewise, pursuant to *Carpenter*, the scope of liability under the Misappropriation Theory is nearly unrestricted. *Id.* at 407. By premising liability on the breach of a fiduciary duty and later use of information based on this breach, the Second Circuit expanded the number of people subject to liability under the Misappropriation Theory. *Id.* Unfortunately, as it did in *Newman*, the Second Circuit failed to explain the parameters of this fiduciary duty requirement and detail the kinds of fiduciary duties that could give rise to Rule 10b-5 violations under the Misappropriation Theory.

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

106. *Id.* at 26.

107. *Id.* at 24.

108. *Id.*

109. Painter et al., *supra* note 4, at 170.

110. Hall, *supra* note 81, at 878.

sion when it passed the Insider Trading Sanctions Act (ITSA) in 1984 and the Insider Trading and Securities Fraud Enforcement Act (ITSFEA) in 1988.¹¹¹ Supposedly, these acts were “to provide greater deterrence, detection, and punishment of violations of insider trading.”¹¹² But, while increasing fines and prison terms, Congress did nothing to define the Misappropriation Theory.¹¹³ In fact, Congress did not even amend Rule 10b-5.¹¹⁴

Instead, Congress cited examples illustrating the increase in insider trading cases.¹¹⁵ Congress did acknowledge that the Misappropriation Theory remained unresolved nationally and even “recognized the continuing concern over a definition of insider trading.”¹¹⁶ Nonetheless, Congress said nothing else about the Theory except to conclude, “this type of security fraud [referring to the Misappropriation Theory] should be encompassed within Section 10b and Rule 10b-5.”¹¹⁷ Congress also recognized that it was important to establish specific guidelines that were subject to criminal penalties.¹¹⁸ However,

111. H.R. REP. NO. 100-910, *supra* note 19, at 7. The ITSA made it illegal to trade derivative securities in situations where trading on the underlying security was prohibited. Brief of Amici Curiae Law Professors and Counsel in Support of Respondent at 12, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 143793) (citing Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264, 1265). This demonstrates that Congress knew about the extent of Rule 10b, “which some courts had held not to extend to trades with options dealers to whom an insider owes no fiduciary duty.” *Id.* (citing *Laventhall v. Gen. Dynamics Corp.*, 704 F.2d 407, 411-12 (8th Cir. 1983)). The ITSA also demonstrates that Congress knew how to expand the prohibition of insider trading under the 1934 Act. *Id.*

112. H.R. REP. NO. 100-910, *supra* note 19, at 7. Among other things, the ITSA increased maximum fines for criminal violations from \$10,000 to \$100,000. *Id.* at 11. Similarly, the ITSFEA increased jail terms for those convicted of securities violations. *Id.* at 7.

113. *Id.* Some members of Congress proposed legislation that would define illegal uses of misappropriated information. Brief of National Association of Criminal Defense Lawyers as Amicus Curiae in Support of Respondent at 9, *United States v. O'Hagan*, (1997) (No. 96-842) (1997 WL 145007). Specifically, this legislation would have made it unlawful to trade on material nonpublic information obtained by “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.” *Id.* (quoting *The Insider Trading Proscriptions Act of 1987: Hearing Before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, 100th Cong.* at 28-30 (1987)). Congress omitted this proposed legislation when it enacted the ITSEA. *Id.*

114. *Id.* at 8.

115. H.R. REP. NO. 100-910, *supra* note 19, at 11-14.

116. *Id.* at 10.

117. *Id.* This language has been used to argue that Congress approved the Misappropriation Theory. However, during passage of the ITSFEA, the House committee stated that it did not “intend to alter the substantive law with respect to insider trading with this legislation.” Brief of National Association of Criminal Defense Lawyers as Amicus Curiae in Support of Respondent at 16, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 145007) (quoting H.R. REP. NO. 100-910, *supra* note 19, at 11).

118. *Id.* For instance, during his introduction of the 1987 Insider Trading Proscriptions Act, Senator Alphonse D'Amato said,

the 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.

133 CONG. REC. S 8252 (daily ed. June 17, 1987) (statement of Sen. D'Amato).

Congress declined to include a statutory definition of the Theory.¹¹⁹ Sadly, the ITSA and the ITSFEA represent the only attempts by Congress to define illegal trading since it passed the 1934 Act.¹²⁰

E. *The Theory Unravels*

With little guidance from Congress or the Supreme Court, federal courts continued to apply the Misappropriation Theory.¹²¹ However, in *United States v. Bryan*,¹²² the U.S. Court of Appeals for the Fourth Circuit reversed a defendant's conviction based on the Misappropriation Theory.¹²³ The Fourth Circuit's decision is significant for two reasons. First, the court held that the language of Rule 10b-5 did not support the Misappropriation Theory as a form of criminal liability.¹²⁴ The decision marked the first time a court flatly rejected the Theory. Second, the court exposed the Theory's shortcomings and its illogical reliance on the breach of a fiduciary duty as a necessary element.¹²⁵ The court's analysis launched several points of criticisms against the Theory.

1. *A Statutory Stretch*

One of the major criticisms of the Misappropriation Theory is that it lacks significant statutory basis. The Theory separates the unifying concept set out in Rule 10b-5 that requires a "deception" that is "in connection with the purchase or sale of a security."¹²⁶ The first requirement, deception, occurs when a person makes a material representation of, or fails to disclose, "material information in violation of a duty to disclose."¹²⁷ The second requirement is that the victims of deception be purchasers or sellers in the securities market. At most,

119. H.R. REP. NO. 100-910, *supra* note 19, at 11. Congress cited two reasons for its refusal to act: Courts have established clear guidelines for insider trading cases and any statutory definition could narrow or invite evasion of the law; and lack of consensus over the definition of insider trading should not prevent passage of needed enforcement reforms. *Id.*

120. Painter et al., *supra* note 4, at 202.

121. See, e.g., SEC v. Peters, 915 F.2d 1162 (10th Cir. 1992); SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); Rothberg v. Rosenbloom, 771 F.2d 818 (3d Cir. 1985).

122. 58 F.3d 933 (4th Cir. 1995). The defendant in *United States v. Bryan* was a state lottery director. *Id.* at 937. Among other things, he was required to negotiate and secure contracts on behalf of the lottery. *Id.* As director, the defendant received material nonpublic information about the companies that contracted with the lottery. *Id.* The defendant then used this information to trade on these companies' shares. *Id.*

123. *Id.* at 961.

124. *Id.* at 944.

125. *Id.* at 943-59.

126. *Id.* at 945-48. The Misappropriation Theory "artificially divides into two discrete requirements—a fiduciary breach and a purchase or sale of securities—the single indivisible requirement of deception upon the purchaser or seller of securities, or upon some other person intimately linked with or affected by a securities transaction." *Id.* at 950.

127. *Bryan*, 58 F.3d at 946 (quoting *Santa Fe Indus. v. Green*, 430 U.S. 462, 470 (1977)).

this includes people “with a similar stake in an actual or proposed securities transaction.”¹²⁸

The Misappropriation Theory does not involve deception as defined in Rule 10b-5.¹²⁹ Instead, the Theory criminalizes the mere breach of a fiduciary duty or similar relationship of trust and confidence.¹³⁰ The Theory further divides this breach into a fiduciary breach and the purchase or sale of securities.¹³¹ The fiduciary breach requirement stretches the language of deception in Rule 10b-5.¹³² Not all breaches of fiduciary duties violate Rule 10b-5.¹³³ For instance, when the news columnist in *Carpenter* leaked information to two stockbrokers, he breached a fiduciary duty. However, the breach alone did not give rise to liability under Rule 10b-5. Such liability only arose when the brokers used the information to trade stocks.

Moreover, the duty to disclose information under Rule 10b-5 arises only when a person is under an affirmative duty to disclose.¹³⁴ This affirmative duty does not arise merely because a person has some position in the securities market.¹³⁵ Rather, the duty arises because of a relationship that the parties share.¹³⁶ Thus, it cannot be said that a physician who discovers from his patient that her husband is about to become chief executive officer of a company has a duty to disclose such information. It cannot even be said that the wife must disclose or not disclose the information. Yet, the Misappropriation Theory would allow the prosecution of the physician and the wife for securities violations under Rule 10b-5.

The Misappropriation Theory likewise fails to meet Rule 10b-5’s mandate that the violation occur “in connection with a securities transaction.”¹³⁷ As the Supreme Court held, Rule 10b-5 would “surely [be] badly strained [if] construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large.”¹³⁸ The Misappropriation Theory specifically targets the world at large. Under a Misappropriation Theory scenario, nondisclosure is misrepresentation committed upon the source of the information.¹³⁹

128. *Id.*

129. *Id.* at 944.

130. *Id.*

131. *See id.* at 950.

132. *Id.* at 945.

133. *See id.* at 946.

134. *Id.*

135. *Id.* at 947.

136. *See id.*

137. *Id.* at 949; *see also* 17 C.F.R. § 240.10b-5 (2001).

138. *Bryan*, 58 F.3d at 948 (quoting *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n.5 (1975)).

139. *See id.*

But this source is usually someone with no connection whatsoever to the securities market.¹⁴⁰

2. *The Choice-of-Law Conundrum*

The Misappropriation Theory also suffers from a choice-of-law problem that has no clear answer.¹⁴¹ Given that insider trading is based on a federal statute and that the Misappropriation Theory has been developed through the federal courts, perhaps federal common law defines the fiduciary duties that give rise to liability.¹⁴² State law may apply because most fiduciary duties are a product of state common law.¹⁴³ However, application of either federal or state law creates problems for establishing the parameters of the fiduciary duty analysis.

The Supreme Court has counseled against relying on federal common law as a source for defining fiduciary duties.¹⁴⁴ Federal courts, the authors of the Misappropriation Theory, have been given many opportunities to provide guidance, and have utterly failed.¹⁴⁵ Moreover, it would violate the principles of federalism for federal courts to create one federal common law that covers the wide range of relationships that are vulnerable to the Misappropriation Theory.¹⁴⁶ Furthermore, until recently, the duty to disclose or abstain was the only duty in relation to Rule 10b-5 that was a product of federal common law.¹⁴⁷ But then the Supreme Court held that the Misappropriation Theory imposes a duty of confidentiality owed to the source of information, not a duty to disclose or abstain.¹⁴⁸ Given this inconsistency, federal common law is not a viable choice of law for defining fiduciary duties.¹⁴⁹

Relying on state law as the source for the fiduciary duty analysis is also problematic.¹⁵⁰ Various fiduciary duties arise depending on the type of fiduciary relationship.¹⁵¹ In addition, states do not uniformly address the question of fiduciary duties.¹⁵² What may be a breach of fiduciary duty in one state may not be in another.¹⁵³ Moreover, some of the relationships involved in prosecutions under the Misappropriation

140. *See id.*

141. *Id.* at 952; *see also* Ramirez & Gilbert, *supra* note 5, at 187-97.

142. Ramirez & Gilbert, *supra* note 5, at 187.

143. *Id.*

144. *See id.* at 189.

145. *Id.* at 190.

146. *See id.*

147. *Id.*

148. *Id.*

149. *Id.* at 191.

150. *Id.* at 197-99.

151. *Id.*

152. *Id.* at 199.

153. *Id.*

tion Theory, such as father/son and physician/patient, have never been held to involve fiduciary duties under state law.¹⁵⁴

The Misappropriation Theory also fails to uphold the policies that Rule 10b-5 was intended to promote because of its reliance on the breach of a fiduciary duty. For example, there is no liability if a principal permits the misappropriator of material nonpublic information to trade.¹⁵⁵ In fact, even if the principal does not consent, the fiduciary is still not liable under the Theory and can even make trades if he simply discloses his intent to trade based on the information.¹⁵⁶ In both of these situations public confidence in the securities market is still damaged. Investors would still feel as though the playing field is not level. As such, the Misappropriation Theory's breach of fiduciary duty requirement does not comport with the policies of deterring insider trading.

The Misappropriation Theory is also problematic in that it amounts to a common law crime.¹⁵⁷ It extends the statutory language of the provision upon which it purportedly rests: Rule 10b-5.¹⁵⁸ The lower federal courts developed the Theory on a case-by-case basis.¹⁵⁹ The Theory centers on a fiduciary duty analysis that relies on state or common law duty.¹⁶⁰ Although several federal circuits have adopted the Theory as a basis for criminal liability, they are divided as to what conduct is prohibited.¹⁶¹

154. *Id.* (citing *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985) (providing no law to support that a father/son relationship gave rise to a fiduciary duty to refrain from trading on material nonpublic information)); *id.* (citing *United States v. Willis*, 737 F. Supp. 269 (S.D.N.Y. 1990) (providing no law to support that a psychiatrist/patient relationship gave rise to a fiduciary duty to abstain from trading on material nonpublic information)).

155. *United States v. O'Hagan*, 521 U.S. 642, 655 (1997).

156. *Id.* The majority conceded that

full disclosure forecloses liability under the misappropriation theory: Because the deception essential to the misappropriation theory involves feigning fidelity to the source of the 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 §10b violation.

Id.

157. Brief of National Association of Criminal Defense Lawyers as Amicus Curiae in Support of Respondent at 6, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 145007).

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.* "The Seventh Circuit applies the theory only to breaches of a fiduciary relationship such as employment." Brief of National Association of Criminal Defense Lawyers as Amicus Curiae in Support of Respondent at 7, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 145007) (citing *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991) (internal quotations omitted)). "By contrast, the Second and Ninth Circuits prohibit any breach of a relationship of trust and confidence." *Id.* (citing *SEC v. Clark*, 915 F.2d 439, 443-44 (9th Cir. 1990); *SEC v. Materia*, 745 F.2d 197, 201-02 (2d Cir. 1984) (internal quotations omitted)).

F. *The U.S. Supreme Court Rubberstamps the Misappropriation Theory*

In 1997, the U.S. Supreme Court, in *United States v. O'Hagan*,¹⁶² had an opportunity to put these criticisms of the Misappropriation Theory to rest. However, the Court passed up the opportunity and merely held that criminal liability under Rule 10b-5 could be predicated on the Misappropriation Theory.¹⁶³ Despite this holding, criticisms of the Theory remain. Specifically, *O'Hagan* does not resolve the deficiencies of the fiduciary duty requirement. To demonstrate this point, it is necessary to examine the Court's reasoning and highlight the questions it leaves unanswered.

In July of 1988, Grand Metropolitan (Grand Met) retained Dorsey & Whitney as local counsel to represent it in a potential offer for the common stock of Pillsbury Company.¹⁶⁴ James Herman O'Hagan was a partner at Dorsey & Whitney but did not do any work on the Grand Met representation.¹⁶⁵ In August 1988, O'Hagan began purchasing call options for Pillsbury stock.¹⁶⁶ Two months later Dorsey & Whitney withdrew its representation of Grand Met.¹⁶⁷ Grand Met subsequently announced its tender offer and the price of Pillsbury stock increased to sixty dollars per share.¹⁶⁸ O'Hagan sold all of his call options and Pillsbury stock, reaping \$4.3 million in profits.¹⁶⁹

An SEC investigation of O'Hagan culminated in a fifty-seven count indictment.¹⁷⁰ Among other charges, the SEC alleged that, under the Misappropriation Theory, O'Hagan violated Rule 10b-5 because he misappropriated material nonpublic information from Dorsey & Whitney and Grand Met and used it to trade stocks.¹⁷¹ A jury convicted O'Hagan on all counts, and he was sentenced to forty-one months in prison.¹⁷²

After the U.S. Court of Appeals for the Eighth Circuit reversed his conviction, the U.S. Supreme Court recognized the circuit split regarding the Misappropriation Theory and granted certiorari to hear O'Hagan's case.¹⁷³ The Court reversed the Eighth Circuit's decision,

162. 521 U.S. 642 (1997).

163. *United States v. O'Hagan*, 521 U.S. 642, 650 (1997).

164. *Id.* at 647.

165. *Id.* Each call option gave O'Hagan the right to buy 100 shares of Pillsbury stock. *Id.* By September of 1988, O'Hagan owned 2,500 Pillsbury options and bought 5,000 shares of Pillsbury common stock for approximately thirty-nine dollars per share. *Id.* at 647-48.

166. *Id.*

167. *Id.* at 647.

168. *Id.* at 648.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.* at 649. On appeal, O'Hagan claimed that his conviction under the Misappropriation Theory could not stand for several reasons. *Id.* O'Hagan argued that the Theory did not com-

holding that criminal liability could be sustained under the Misappropriation Theory.¹⁷⁴

The Court stated that the Misappropriation Theory satisfied Rule 10b's requirement of deception because misappropriators deal in deception.¹⁷⁵ The Court further explained that "[a] fiduciary who [pretends] loyalty to the principal while secretly converting the principal's information for personal gain . . . 'dupes' or defrauds the principal."¹⁷⁶ The Court emphasized that deception occurred because of nondisclosure, which was central to the Misappropriation Theory.¹⁷⁷ As such, O'Hagan had an obligation to disclose that he would trade on the basis of the material nonpublic information.¹⁷⁸ This obligation ran to the sources of the information, which were Dorsey & Whitney and Grand Met.¹⁷⁹

In addition, the Court stated that the Misappropriation Theory satisfied Rule 10b's "in connection with securities" requirement.¹⁸⁰ The Court explained that this requirement was satisfied because fraud is not complete until the person gains the information and uses it to purchase and sell securities without disclosure to the principal.¹⁸¹ The breach of fiduciary duty and the securities transaction occur at the same time.¹⁸² Thus, O'Hagan profited by trading on material nonpublic information without disclosing the information to his employer and Grand Met.

The Court was not concerned that the defrauded party was the source of the information rather than the other party to the securities transaction.¹⁸³ The Court interpreted Rule 10b as "deception in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller.¹⁸⁴ The Court reasoned that the Mis-

port with the language of Rule 10b-5, did not require deception, did not satisfy the "in connection with securities" requirement, and violated his due process because it failed to define what conduct was illegal. *Id.*

174. *Id.* at 649-50.

175. *Id.* at 655. The *O'Hagan* Court hailed the government's Misappropriation Theory as consistent with *Santa Fe Indus. v. Green*, "a decision underscoring that §10(b) is not an all-purpose breach of fiduciary duty ban; rather, it trains on conduct involving manipulation or deception." *Id.* at 655 (quoting *Santa Fe Indus. v. Green*, 430 U.S. 462, 473-476 (1977)). To satisfy *Santa Fe*'s mandate, the *O'Hagan* Court separated the use of misappropriated information from the misappropriator's failure to notify the source of the intent to use stolen information to trade. Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1276 (1998). Unfortunately, the misappropriator's failure to disclose the intent to trade does not cause harm to investors or the market. *See id.* at 1276-77.

176. *O'Hagan*, 521 U.S. at 653-54 (internal citations omitted).

177. *Id.* at 654.

178. *See id.* at 654-55.

179. *Id.*

180. *Id.* at 656.

181. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

appropriation Theory did not target all forms of fraud involving deception.¹⁸⁵ Instead, the Theory “catches fraudulent means of capitalizing on such information through securities transactions.”¹⁸⁶

The Court claimed that the Misappropriation Theory was consistent with its precedent.¹⁸⁷ In *O’Hagan*, the Court explained that its language in *Chiarella* did not mean that the sole relationship triggering liability based on undisclosed information was between a corporation and its shareholders and insiders.¹⁸⁸ Moreover, *Chiarella* specifically left open the issue of the printer’s liability because it was not submitted to the jury.¹⁸⁹ The *O’Hagan* Court felt *Chiarella* left open the validity of the Theory for its determination.¹⁹⁰ Therefore, *Chiarella* could not be read as rejecting the Misappropriation Theory.¹⁹¹

185. *Id.*

186. *Id.*

187. *Id.* at 660. During its review of *O’Hagan*, the Eighth Circuit claimed that three of the U.S. Supreme Court’s decisions revealed that Rule 10b liability could not be based on a duty owed to the source of the nonpublic information. *Id.* One of these decisions was *Chiarella v. United States*, 445 U.S. 222 (1980). The *O’Hagan* Court emphasized that in *Chiarella*, the defendant had no fiduciary or other relationship of trust or confidence with the sellers. *O’Hagan*, 521 U.S. at 661. In *Chiarella*, the Court said that a duty to disclose or abstain from trading arose from a specific relationship between the parties. *Chiarella*, 445 U.S. at 233. Moreover, Rule 10b premised this duty on a relationship of trust or confidence between parties to a transaction. *Id.* As such, the *Chiarella* Court held that liability based on such a broad theory could not be imposed on the defendant. *Id.* The other two decisions cited by the Eighth Circuit were *Dirks v. SEC*, 463 U.S. 646 (1983) and *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). For a comprehensive analysis of the U.S. Supreme Court’s precedent involving Rule 10b-5 leading up to *O’Hagan*, see Ramirez & Gilbert, *supra* note 5, at 170-80.

188. *O’Hagan*, 521 U.S. at 661.

189. *Id.* at 662.

190. *Id.*

191. *Id.* However, in *Chiarella*, the justices who discussed the Misappropriation Theory had a different version from that expounded by the government and adopted by the Supreme Court in *O’Hagan*. In his concurring opinion in *Chiarella*, Justice Stevens stated that an argument could be made that “inasmuch as [the acquiring companies] would not be able to recover damages from petitioner for violating Rule 10b-5 because they were neither purchasers or sellers of target company securities, . . . no actionable violation occurred.” *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring). Justice Brennan, who concurred only in the judgment, disagreed with the majority’s suggestion that in the absence of a breach of some fiduciary relationship between buyer and seller, there could be no Rule 10b violation. *Id.* at 239 (Brennan, J., concurring in the judgment). Chief Justice Burger’s version of the Theory in *Chiarella* had the duty to disclose running to the source of the information and to those with whom the misappropriator traded. *Id.* at 243 (Burger, C.J., dissenting).

In his dissent, Justice Blackmun, joined by Justice Marshall, argued that the focus should be on a person’s illegal access to material nonpublic information rather than a fiduciary relationship. *Id.* at 247 (Blackmun, J., dissenting). Justice Blackmun stated that “[t]he duty to abstain or disclose arose, not merely as an incident of fiduciary responsibility, but as a result of the ‘inherent unfairness’ of turning secret information to account for personal profit.” *Id.* at 249 (Blackmun, J., dissenting). On the other hand, in *O’Hagan*, under the government’s version of the Theory, O’Hagan breached a duty of trust or confidence he owed to Dorsey & Whitney and Grand Met when he stole material nonpublic information from them and used it to trade on Pillsbury’s stock. *O’Hagan*, 521 U.S. at 653, 655 n.6. O’Hagan’s obligation to disclose the information, under the government’s theory, only ran to the sources of the information, which were Dorsey & Whitney and Grand Met. *Id.* However, just because the justices in *Chiarella* discussed a different version of the Theory does not support the Court’s decision to uphold the government’s version of the Theory and send O’Hagan to prison.

The Court also noted that *Dirks v. SEC*¹⁹² left open the application of the Misappropriation Theory for cases such as *O'Hagan*.¹⁹³ In *Dirks*, the defendant, an investment analyst, received information from a former insider of a corporation alleging the corporation engaged in fraud.¹⁹⁴ The defendant, who had no connection with the former insider, investigated the fraud and obtained corroborating information from the corporation's employees.¹⁹⁵ During his investigation, the defendant discussed his findings with clients and investors.¹⁹⁶ Some of these people sold their holdings in the corporation.¹⁹⁷ Although the SEC used information from *Dirks*'s investigation to convict other individuals, the SEC censured him.¹⁹⁸ The SEC felt that as a "tippee" of the corporation's insiders, the defendant had a duty under Rule 10b-5 to refrain from disclosing his findings to individuals who were likely to trade on it.¹⁹⁹

The *O'Hagan* Court noted that in *Dirks*, it disagreed with the SEC, and reiterated its holding in *Chiarella* that there was no "general duty between all participants in market transactions to forgo actions based on material, nonpublic information."²⁰⁰ The *O'Hagan* Court also stated that there was no evidence in *Dirks* that the insiders violated any duty to their employer by disclosing information to the defendant.²⁰¹ These insiders were not acting for personal profit.²⁰² Instead, they were trying to expose fraud.²⁰³

Most importantly, the *O'Hagan* Court asserted that in *Dirks* the defendant's sources could not expect that the defendant would keep their information confidential.²⁰⁴ Moreover, the defendant had not misappropriated or obtained the information illegally.²⁰⁵ Accordingly, the *O'Hagan* Court defended its holding as consistent with *Dirks* because *Dirks* did not indicate that "a person who gains non-public information through misappropriation in breach of a fiduciary duty escapes § 10(b) liability when, without alerting the source, he trades on the information."²⁰⁶

192. 463 U.S. 646 (1983).

193. *O'Hagan*, 521 U.S. at 662.

194. *Dirks v. SEC*, 463 U.S. 646, 648-49 (1983).

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.* at 650-51.

199. *Id.*

200. *United States v. O'Hagan*, 521 U.S. 642, 663 (1997)(quoting *Dirks*, 463 U.S. at 655).

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.*

The Court also stated that its adoption of the Misappropriation Theory was consistent with *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*²⁰⁷ In *Central Bank of Denver*, the Court forbade private plaintiffs from bringing an aiding and abetting suit under Rule 10b.²⁰⁸ The Court also emphasized that it was “inconsistent with settled methodology in Rule 10b cases to extend liability beyond the scope of conduct prohibited by the statutory text.”²⁰⁹

In addition to following precedent, the Court also defended the Misappropriation Theory as being “well tuned to the animating purpose of the [1934 Act]: to insure [sic] honest securities markets and thereby promote investor confidence.”²¹⁰ Finally, the Court argued that Congress, through enactment of legislation regarding scienter, supported the Misappropriation Theory and provided “sturdy safeguards” in two ways.²¹¹ First, Congress required the government to prove a person willfully violated Rule 10b-5 to establish a criminal violation.²¹² Second, a person could not be imprisoned under the Misappropriation Theory if he proved he was unaware of Rule 10b-5.²¹³

Under *O’Hagan*, a violation of the Misappropriation Theory occurs when a person “deceptively misappropriates material nonpublic information in breach of a fiduciary duty and uses that information in a securities transaction.”²¹⁴ This fiduciary duty requirement is significant for two reasons.²¹⁵ First, the existence of a fiduciary duty means a misappropriator must disclose his intention to trade to the source of

207. *Id.* at 663-64.

208. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 191 (1994).

209. *Id.* at 177. The Eighth Circuit used *Central Bank* to support its rejection of the Misappropriation Theory, claiming that Rule 10b covered only deceptive statements or omissions on which purchasers, sellers, and other market participants rely. *United States v. O’Hagan*, 92 F.3d 612, 618 (8th Cir. 1996). However, the *O’Hagan* Court argued that in *Central Bank*, it also cautioned that secondary actors such as lawyers and accountants could be liable for “[employing] a manipulative device or [making] a material misstatement (or omission) on which a purchaser or seller of securities relies.” *O’Hagan*, 521 U.S. at 664.

210. *O’Hagan*, 521 U.S. at 658 (quoting 45 Fed. Reg. 60,412 (1980)). The Court acknowledged that informational advantages were inevitable in the securities markets. *Id.* However, it argued that if the misappropriation of nonpublic information were permitted, investors would hesitate to participate in the market. *Id.* Likewise, the Court noted that a misappropriator’s acquisition of nonpublic information did not come about through good fortune, but fraud. *Id.* at 658-59. The Court felt that market research and skill could not stand a chance against such intentional conduct. *Id.* at 659.

211. *Id.* at 665. Despite these two “sturdy” safeguards, the *O’Hagan* Court failed to articulate “a standard of proof for a willful violation.” Jason Anthony et al., *Securities Fraud*, 36 AM. CRIM. L. REV. 1095, 1111 (1999).

212. *O’Hagan*, 521 U.S. at 665.

213. *Id.* at 666. The Court stated that the Theory’s limitation to people who breach a recognized duty defeated O’Hagan’s argument that the Theory was too indefinite. *Id.* In addition, Congress’s requirement of culpable intent as a prerequisite to liability destroyed “any force in the argument that application of [Rule 10b-5] in circumstances such as O’Hagan’s was unjust.” *Id.*

214. Ramirez & Gilbert, *supra* note 5, at 165.

215. *Id.* at 181.

the information.²¹⁶ Second, the breach of this fiduciary duty constitutes fraud for the purposes of Rule 10b-5.²¹⁷ This breach deprives the principal, or the source of the information, of the exclusive right to the use of the information.²¹⁸ This breach is “in connection with a securities transaction” because the misappropriator uses the information to purchase and sell securities.²¹⁹

Although *O'Hagan* held that the Misappropriation Theory supports criminal liability under Rule 10b-5, the case does little to define the fiduciary relationships that give rise to such liability. Instead, it creates several problems and leaves other issues unresolved.²²⁰ For instance, the Court focused on O'Hagan's duties toward Dorsey & Whitney and Grand Met. But, even if O'Hagan breached any duties to Dorsey & Whitney, it would only constitute a violation of an employment policy. Why does the violation of an employment policy land O'Hagan in prison? With respect to Grand Met, the firm's client, O'Hagan had a duty not to disclose information that Dorsey & Whitney obtained in the course of their representation of Grand Met.²²¹ However, nothing prevented O'Hagan from trading on the basis of this information. He did not disclose this information to anyone; he merely used it to purchase and sell Pillsbury's securities. Moreover, Grand Met suffered no harm.

Another problem with the Court's analysis in *O'Hagan* is that it simply defines the Misappropriation Theory as a fraud on the source of the material nonpublic information that is ultimately used in a trade. However, the Court conceded that liability vanishes if there is full disclosure to the source of the information.²²² The Court stated that with full disclosure, “there is no deceptive device.”²²³ Thus, O'Hagan would not be in prison had he simply told Dorsey & Whitney and Grand Met that he was going to trade Pillsbury stock using the nonpublic information he obtained.²²⁴ Alternatively, if Grand Met gave O'Hagan permission to trade, he would not be in

216. *Id.*

217. *Id.*

218. *O'Hagan*, 521 U.S. at 652.

219. *Id.*

220. A couple of months after *O'Hagan*, former SEC Enforcement Director William McLucas said that “the high court's ruling still leaves several issues open, including the question of when a duty is owed—in what kinds of relationships and under what circumstances.” Diamond, *supra* note 9, at 2. McLucas noted that other unresolved issues included the standard for insider trading liability and the state of mind requirement. *Id.* On the question of whether a particular relationship will give rise to a fiduciary duty, McLucas said, “I expect that's going to continue to be an issue.” *Id.*

221. MODEL RULES OF PROF'L CONDUCT R. 1.6, 1.8 reprinted in PROFESSIONAL RESPONSIBILITY STANDARDS, RULES & STATUTES 21, 31-32 (John S. Dzienkowski ed., 2000-2001).

222. *O'Hagan*, 521 U.S. at 655.

223. *Id.*

224. The Court conceded that if the source of the information permits the misappropriator to trade, then there is also no liability. *Id.*

prison. This means that the source of the information holds the keys to the jailhouse door. Whether or not there is disclosure or consent, the fact remains that O'Hagan would be trading stocks with material nonpublic information. This still harms investor confidence and undermines the integrity of the market. Therefore, given its concessions regarding the Misappropriation Theory, the Court's reliance on it to enforce the overall policies of Rule 10b is misplaced.

O'Hagan leaves many criticisms of the Misappropriation Theory unanswered.²²⁵ The Court failed to address the Theory's departure from the language of Rule 10b-5.²²⁶ Instead, like the lower federal courts' applications of the Theory, the Supreme Court separated deception and the securities connection by holding that breach of a fiduciary relationship was fraudulent because it deprived the source of the exclusive right to use the information.²²⁷ The Court also failed to indicate what law provided the source for the fiduciary duty analysis.²²⁸ The Court departed from earlier decisions and held that the Theory imposed a duty of confidentiality.²²⁹ Most importantly, the Court failed to establish any parameters for defining the fiduciary duties that trigger liability under the Misappropriation Theory.²³⁰

III. ANALYSIS

A. *Why Fiduciary Duties Need to Be Defined*

Two decades have passed since the birth of the Misappropriation Theory.²³¹ Yet neither the courts nor Congress have offered any principled basis for determining which relationships may give rise to criminal liability under the Theory.²³² It is even unclear whether a putative defendant should look to state or federal law in determining the scope of fiduciary duties for the purpose of the Misappropriation Theory. Defining these relationships is necessary not only for bringing the Theory within the ambit of Rule 10b-5, but also for avoiding further expansion of the Theory²³³ and resolving the constitutional concerns

225. Ramirez & Gilbert, *supra* note 5, at 187.

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. This history is explained *supra* note 54.

232. Painter et al., *supra* note 4, at 188.

233. Lower courts after *O'Hagan* advocated further extension of the Theory. For example, in *SEC v. Yun*, David Yun told his wife, the defendant, about the impending drop in his company's stock price while the couple was negotiating the division of its marital assets. 130 F. Supp. 2d 1348, 1354 (M.D. Fla. 2001). A judge ruled that during this negotiation, there was no fiduciary duty between the Yuns under Florida law. *Id.* After the government presented its case, the wife moved for judgment as a matter of law, arguing that this ruling foreclosed the case because the SEC could not establish she obtained the information as part of a fiduciary relationship. *Id.* The District Court for the Middle District of Florida disagreed, stating that the jury could consider the negotiations to determine whether a duty of trust or confidence existed between the

of notice and vagueness that plague this standard of criminal liability.²³⁴

If defendants are to be imprisoned for their behavior, fundamental notions of due process require that they be given notice as to what behavior is criminal.²³⁵ The lack of definition regarding the fiduciary analysis of the Misappropriation Theory fails to provide this notice.²³⁶ For the most part, federal courts have developed the Misappropriation Theory on a case-by-case basis.²³⁷ This may be an appropriate way to secure investor confidence through civil liability. However, this use of criminal liability in an ill-defined way is untethered to market harm or damage to a victim. It amounts to randomly sacrificing individuals on the altar of investor confidence.²³⁸

This ambiguity in turn renders the Misappropriation Theory a vague standard of criminal liability.²³⁹ “Principles of fairness dictate

couple. *Id.* at 1355. The court claimed this was consistent with *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991), which implied “that a non-formal fiduciary-like relationship can be the basis for liability under [the] misappropriation theory.” *Id.*

In *SEC v. Sargent*, Dennis J. Shepard and J. Anthony Aldrich were the sole shareholders of a consulting firm. 229 F.3d 68, 71 (1st Cir. 2000). Aldrich, a member of Purolator Products’ board of directors, told Shepard that Purolator was going to be bought. *Id.* Shepard, who agreed to keep the information confidential, later told the defendant, his long-time friend, that he knew of a company that would be bought but could not buy stock in it because he was “too close to the situation.” *Id.* at 71-72. The SEC alleged Shepard told the defendant the company was Purolator. *Id.* The defendant subsequently told his broker he heard Purolator would be bought and purchased two thousand shares of the company’s stock. *Id.* The SEC sued both Sargent and Shepard, alleging they traded on the material nonpublic information Shepard misappropriated from Aldrich. *Id.* at 75. Shepard argued there was no breach of a fiduciary duty because the information about Purolator was unrelated to the consulting firm. *Id.* at 76. The U.S. Court of Appeals for the First Circuit disagreed and recognized a fiduciary duty arose out of their status as sole shareholders of their closely held corporation. *Id.* The court found that “a jury could reasonably find that Shepard and Aldrich expected that confidential business matters, even those unrelated to the consulting firm, would be held in trust and that Shepard thereby owed a fiduciary duty to safeguard information relating to Purolator.” *Id.*

234. Painter, *supra* note 4, at 187.

235. *Id.* at 188.

236. *Id.* “[A]pplication of [the Misappropriation Theory] . . . would violate due process and transgress the doctrines of fair notice, lenity and strict construction, and, thus, such a construction should be avoided.” Brief of Respondent at 30, *United States v. O’Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 143801). “It is axiomatic that [d]ue process requires that a criminal statute provide adequate notice to a person of ordinary intelligence that his contemplated conduct is illegal, for no man shall be held criminally responsible for conduct which he could not reasonably understand to be proscribed.” *Id.* (quoting *Buckley v. Valeo*, 424 U.S. 1, 77 (1976) (internal citations omitted)). “[A] judicial holding that certain undefined activities ‘generally prohibited’ by [Rule 10b] would raise questions whether either criminal or civil defendants would be given fair notice that they have engaged in illegal activity.” *Id.* (quoting *Chiarella v. United States*, 445 U.S. 222, 235 n.20 (1980)). “The misappropriation theory offends due process because it lacks definiteness.” *Id.*

237. Painter et al., *supra* note 4, at 196.

238. See *supra* Part I; *infra* text accompanying notes 288-97.

239. Painter et al., *supra* note 4, at 196.

But one cannot lawfully be convicted of a federal crime for violating a plausible theory of what a statute may mean. Rather, the Courts must be able to discern, from the language chosen by Congress to describe its prohibition or from the circumstances of the law’s enactment, an exercise of political will to criminalize the course of conduct encompassed by the theory. The misappropriation theory does not meet this standard. Brief of National Association of Criminal Defense Lawyers as Amicus Curiae in Support of Respondent at 17, *United States v. O’Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 145007).

that statutes imposing criminal liability be well defined.”²⁴⁰ Laws defining illegal conduct must “give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly.”²⁴¹ Likewise, “in order to avoid arbitrary and discriminatory enforcement of criminal statutes, laws must provide explicit standards for those who apply them.”²⁴² Three canons of judicial construction arise from these principles.²⁴³

The first states that the legislature and not the courts define crimes and impose punishment.²⁴⁴ This canon of lawmaking mitigates the danger of arbitrary and retrospective application of criminal laws and punishments. Nevertheless, when there is confusion as to who falls within the scope of criminal prohibitions, notions of fairness arise and notice must be given to potential defendants.²⁴⁵

The second canon, known as the rule of lenity, asserts that the defendant must be given the benefit of the doubt when ambiguity plagues the scope of a criminal sanction.²⁴⁶ This canon specifically applies to the Misappropriation Theory. In criticizing the *O’Hagan* majority, Justice Scalia, in dissent, stated, “[T]he Court’s explanation of the scope of §10(b) and Rule 10b-5 would be entirely reasonable in some other context, [but] it does not seem to accord with the principle of lenity we apply to criminal statutes.”²⁴⁷ As such, Rule 10b’s language, “to use or employ in connection with the purchase or sale of any security [and] any manipulative or deceptive device or contrivance . . . must be construed to require the manipulation or deception of a party to a securities transaction.”²⁴⁸ In other words, there must be damage to other investors or market harm. Likewise, Justice Thomas stated that the “misappropriation theory fails to provide a coherent and consistent interpretation of [the requirement that a deceptive device be used or employed in connection with the purchase or sale of any security] for liability under §10(b).”²⁴⁹

240. Painter et al., *supra* note 4, at 197.

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.* at 198.

245. *Id.* In *United States v. Kozminski*, 487 U.S. 931 (1988), the U.S. Supreme Court stated, It is one thing to recognize that some degree of uncertainty exists whenever judges and juries are called upon to apply substantive standards established by Congress; it would be quite another thing to tolerate the arbitrariness and unfairness of a legal system in which the judges would develop the standards for imposing criminal punishment on a case-by-case basis.

Kozminski, 487 U.S. at 951.

246. Painter et al., *supra* note 4, at 198.

247. *United States v. O’Hagan*, 521 U.S. 642, 679 (1997) (Scalia, J., dissenting).

248. *Id.* (Scalia, J., dissenting).

249. *Id.* at 680 (Thomas, J., dissenting).

The last canon holds that criminal statutes must be strictly interpreted.²⁵⁰ In developing the Misappropriation Theory, courts have stretched the language of Rule 10b-5 to criminalize corrupted fiduciary relationships rather than corrupted securities transactions. This leaves market participants with no “guidance as to where the line is between permissible and impermissible disclosures and uses.”²⁵¹ This ignores the U.S. Supreme Court’s instruction that the securities market “demands certainty and predictability [and needs] a guiding principle for those whose daily activities must be limited and instructed by the SEC’s insider trading rules.”²⁵² Therefore, without “clearly defined rules, investors find themselves the targets of ad hoc decision-making or pawns in the overall litigation strategy known only to the SEC.”²⁵³

The Misappropriation Theory violates all of these canons. The courts have transformed a legislatively created prohibition against securities violations into a sweeping standard of criminal liability that intrudes upon the most private relationships. Thus, physicians and their patients, fathers and their sons, hairdressers and their patrons, and former employees and their employers are left to wonder whether they have duties to disclose use of material nonpublic information and whether failure to do so will land them in prison. Often, such relationships of confidence arise without either party’s knowledge. Moreover, parties cannot always know whether their relationships involve fiduciary duties. Individuals must resort to a court or legislative body to define their relationships for them. A clear definition by the SEC would end the ad hoc manner in which the fiduciary duty analysis has developed.²⁵⁴

B. *Why the SEC? Why NOT the SEC?*

The SEC should promulgate a rule defining, in specific detail, the fiduciary duties that give rise to criminal liability under the Misappropriation Theory. Many other entities have either not tried or failed to accomplish this goal. The federal circuits have not solved this problem because they have disagreed over application of the Theory and expanded the reach of Rule 10b-5 to criminalize behavior that has no

250. Painter et al., *supra* note 4, at 199-200.

251. United States v. Bryan, 58 F.3d 933, 951 (4th Cir. 1995) (quoting Dirks v. SEC, 463 U.S. 646, 664 (1983)).

252. *Id.* at 950 (quoting Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 188 (1994)).

253. *Id.* at 951.

254. “[C]ourts are defining ‘misappropriation’ on an ad hoc basis with little notice to putative insider traders of what conduct is prohibited and what conduct is acceptable.” Ramirez & Gilbert, *supra* note 5, at 188. In his dissenting opinion in *O’Hagan*, Justice Thomas called the Misappropriation Theory “no better than an ad hoc interpretation of liability [that] can provide no basis for liability.” *O’Hagan*, 521 U.S. at 692 (Thomas, J., dissenting).

connection with the securities markets and no notice to putative criminals.²⁵⁵ The Supreme Court had an opportunity to resolve the fiduciary duty issue, but merely authorized use of the Theory without defining what duties will give rise to liability under the Theory. The Court also failed to articulate the role of state law or whether federal circuits could make up new duties. Further, the Court did not require the SEC to promulgate rules before putting people in prison. Likewise, Congress has passed two pieces of legislation since the inception of Rule 10b-5, but neither addressed the fiduciary duty issue.

The SEC is in the best position to clarify this mysterious Theory.²⁵⁶ Pursuant to the 1934 Act, Congress created the SEC to oversee and regulate the securities markets.²⁵⁷ Congress also empowered the SEC to enforce the provisions of the 1934 Act.²⁵⁸ Most importantly, Congress granted the SEC rule-making authority.²⁵⁹ Under the legislative authority granted by Rule 10b, the SEC promulgated Rule 10b-5, which is the statutory basis for the Misappropriation Theory.²⁶⁰ In addition to Rule 10b-5, the SEC continues to create rules in response to the evolving securities markets in order to maintain fair markets and protect investors.²⁶¹ Moreover, the SEC is the primary enforcement authority that refers violators of Rule 10b-5 to the Department of Justice for prosecution. Consequently, the SEC is in the best position to define what kinds of relationships trigger liability under the Misappropriation Theory.

255. For example, in *United State v. Reed*, the Second Circuit upheld the lower's court's finding that a son owed his father a fiduciary duty. 773 F.2d 477 (2d Cir. 1985). However, in *Zullig v. Zullig*, the Wyoming Supreme Court found that a son did not owe his father a fiduciary duty. 502 P.2d 198 (Wyo. 1972). In *SEC v. Lenfest*, the court held there was a fiduciary relationship between a husband and wife. 949 F. Supp. 341 (E.D. Pa. 1996). However, in *United States v. Chestman*, the Second Circuit held a fiduciary relationship did not exist between husband and wife. 947 F.2d 551 (2d Cir. 1991).

256. After *O'Hagan*, former SEC Enforcement Director William McLucas noted that the definition of insider trading remained an issue and said, "I think the question of how one defines it, and who's in and who's out, would be the commission's concern. It would certainly be my concern." Diamond, *supra* note 9, at 2.

257. 15 U.S.C. § 78d (1994); *see also id.* at § 78o(f) (1998).

258. *Id.*

259. *Id.*

260. *Id.* at § 78j.

261. U.S. SEC. EXCH. COMM'N, HOW THE SEC PROTECTS INVESTORS, MAINTAINS MARKET INTEGRITY, at <http://www.sec.gov/about/whatwedo.html> (last visited Feb. 9, 2002). The SEC rulemaking process involves three stages. *Id.* The first stage is the concept release, where the SEC issues a release describing the area of interest and the SEC's concerns. The SEC also solicits public comment on the topic. *Id.* The next stage is the rule proposal where a committee drafts a proposed rule and submits it to the SEC for approval. *Id.* Once the rule is approved, the SEC submits it to the public for period of thirty to sixty days. During this period, the public may offer feedback the SEC considers in its draft of the final rule. *Id.* The last stage is rule adoption, in which the committee submits a final draft of the rule to the SEC. *Id.* If the rule is adopted, it becomes part of the official rules. If it is a major rule, it may be subject to congressional review. *Id.*

C. *Insider Trading Is All About Use — Not Confidentiality*

The SEC has recognized the ambiguity surrounding the Misappropriation Theory.²⁶² In an attempt to articulate what circumstances give rise to a duty of trust or confidence under the Misappropriation Theory, the SEC recently created Rule 10b5-2.²⁶³ This rule sets forth a non-exclusive list of three situations in which a person has a duty of trust or confidence for the purposes of the Misappropriation Theory.²⁶⁴ In the preliminary note to this new rule, the SEC states that the “law of insider trading is otherwise defined by judicial opinions construing Rule 10b-5 [and that Rule 10b5-2] does not modify the scope of insider trading law in any respect.”²⁶⁵ In other words, Rule 10b5-2 has no application whatsoever. Defendants still must conform their conduct to pre-existing case law, and in a conflict scenario pre-existing case law must govern. The SEC calls Rule 10b5-2 a broad approach, indicating that it is hesitant to intrude upon details of particular family and personal relationships.²⁶⁶ The SEC also states that the goal of this new rule is to “protect investors and the fairness and integrity of the nation’s securities markets against improper trading on the basis of inside information.”²⁶⁷

While Rule 10b5-2 represents a positive move towards solving the question that the Supreme Court, other federal courts, and Congress have failed to answer, it is still terribly inadequate for the purposes of criminal sanctions unless the SEC rewrites Rule 10b5-2 to say that state law defines the duty of trust or confidence that gives rise to liability under the Misappropriation Theory. The rule suffers from the same inadequacies²⁶⁸ as the judicial opinions that developed the Misappropriation Theory. The rule focuses on mere confidentiality rather than the use of the information and does nothing to protect the integrity of the securities market or promote investor confidence.

The many ways in which a fiduciary can escape Rule 10b-5 liability demonstrate that it is highly problematic to channel the Misappropriation Theory’s focus on the confidentiality between the misappropriator and the source of the material nonpublic informa-

262. U.S. SEC. EXCH. COMM’N, SELECTIVE DISCLOSURE AND INSIDER TRADING, Proposed Rule, at <http://www.sec.gov/rules/proposed/34-42259.htm> (last visited Feb. 4, 2002) [hereinafter Proposed Rule].

263. Rule 10b5-2 went into effect October 23, 2000. U.S. SEC. EXCH. COMM’N, SELECTIVE DISCLOSURE AND INSIDER TRADING, Final Rule, at <http://www.sec.gov/rules/final/33-7881.htm> [hereinafter Final Rule].

264. *Id.* at <http://www.sec.gov/rules/final/33-7881.htm>; see also 17 C.F.R. § 240.10b5-2 (2001).

265. 17 C.F.R. § 240.10b5-2 (2001).

266. Final Rule, *supra* note 263 at <http://www.sec.gov/rules/final/33-7881.htm>.

267. *Id.* at <http://www.sec.gov/rules/final/33-7881.htm>.

268. Rule 10b5-2 “does nothing to clarify the law in any predictable way.” John F. X. Peloso, *SEC Proposals on Selective Disclosures and Insider Trading*, N.Y. L.J., Feb. 17, 2000, at 3.

tion.²⁶⁹ The *O'Hagan* Court stated that a fiduciary was absolved of liability under the Misappropriation Theory if there was disclosure of the nonpublic information to the source or consent from the source to use the information to trade securities.²⁷⁰ Escaping liability with such ease permits someone to gain advantage over investors by using material nonpublic information. This harm is the same with or without the consent of the beneficiary of the fiduciary duty. Unsuspecting investors would still have no chance to obtain material nonpublic information through research and skill.²⁷¹ As Justice Thomas stated, "As far as the market is concerned, a trade based on confidential information is no more 'honest' [just] because some third party may know of it."²⁷² Indeed, the investor on the other side of the trade, the supposed focus of the federal securities laws, would "remain in the dark" either way.²⁷³

If the Misappropriation Theory fails to protect the integrity of the securities market, the question remains whether it protects fiduciary relationships. In some cases, the Theory fails here, too.²⁷⁴ For instance, a misappropriator has no duty to disclose material nonpublic information to those on the other side of the transaction because he has no fiduciary relationship with these individuals.²⁷⁵ As such, it is illogical to require a misappropriator to disclose the same information to his source.²⁷⁶ The Misappropriation Theory requires the trader to disclose his intent to use the information only to the source.²⁷⁷ If a misappropriator discloses his intent to trade, there is no deceptive device and no liability exists under Rule 10b-5.²⁷⁸

Although a misappropriator may be liable for breach of the duty of loyalty under state law, the Misappropriation Theory permits him to escape federal violations through disclosure because there is no deception.²⁷⁹ Despite exemption from federal securities violations, the fiduciary relationship has been harmed by the disloyalty of the misappropriator.²⁸⁰ The Theory does nothing to protect the fiduciary relationship except require disclosure, which only informs the principal of the misappropriator's disloyalty.²⁸¹ Similarly, the Theory permits non-fiduciaries to trade on information obtained without the consent

269. Acoba, *supra* note 14, at 1401.

270. *United States v. O'Hagan*, 521 U.S. 642, 655 (1997).

271. Acoba, *supra* note 14, at 1402.

272. *Id.* (quoting *O'Hagan*, 521 U.S. at 690).

273. *Id.* (quoting *O'Hagan*, 521 U.S. at 690).

274. *Id.*

275. *Id.*

276. *Id.*

277. *United States v. O'Hagan*, 521 U.S. 642, 655 (1997).

278. *Id.*

279. Acoba, *supra* note 14, at 1403.

280. *Id.*

281. *Id.*

of the source.²⁸² For example, the *O'Hagan* Court noted that the Theory would be inapplicable if a non-fiduciary stole O'Hagan's briefcase containing material nonpublic information and then traded securities with the information because there was no deceptive breach of a fiduciary duty.²⁸³ Likewise, if O'Hagan disclosed the information to a non-fiduciary tippee, neither he nor the tippee would be liable under the Misappropriation Theory.²⁸⁴ Unfortunately, in both of these situations, non-fiduciaries would still have an advantage over unsuspecting investors, and the integrity of the market would still be compromised.

The SEC's reliance on confidentiality in Rule 10b5-2 is also troublesome because there may be instances in which the breach of a duty of trust or confidence does not create federal securities violations. Suppose the chief executive officer of a corporation told his wife some material nonpublic information concerning his own corporation. This husband/wife relationship would trigger subsection (b)(3) of Rule 10b5-2.²⁸⁵ Suppose the wife concedes she had a duty of trust or confidence to her husband to keep the information confidential. Suppose further that, without expecting any benefit whatsoever,²⁸⁶ the wife, instead of trading, gets drunk at a bar and tells her friends about the information she received from her husband. If the wife's friends use this information to trade, neither they nor she would be liable for federal securities violations even though the wife clearly violated a duty of trust or confidence.

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."²⁸⁷ First of all, liability under the Misappropriation Theory, as well as Rule 10b5-2, which apparently was written to help define the Theory, does not turn on the effects of damage to the marketplace or buyers and sellers of securities. Instead, liability turns on the breach of a fiduciary duty or

282. *Id.*

283. *Id.* at 1403-04 (quoting Transcript of Oral Argument at 5, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 86306)).

284. *Id.* (quoting Transcript of Oral Argument at 5, *United States v. O'Hagan*, 521 U.S. 642 (1997) (No. 96-842) (1997 WL 86306)).

285. A duty of trust or confidence arises "whenever a person receives or obtains material nonpublic information from his or her spouse . . ." 17 C.F.R. § 240.10b5-2(b)(3) (2001).

286. In *O'Hagan*, the U.S. Supreme Court left its prior decisions regarding Rule 10b and Rule 10b-5 intact. Ramirez & Gilbert, *supra* note 5, at 209. Moreover, the SEC said that "the law of insider trading is otherwise defined by judicial opinions [and that Rule 10b5-2] does not modify the scope of insider trading law in any respect." 17 C.F.R. § 240.10b5-2. One of the decisions the *O'Hagan* Court left intact was *Dirks v. SEC*, 463 U.S. 646 (1983). *O'Hagan*, 521 U.S. at 662-63. In *Dirks*, the Court stated that "the test is whether the [tipper] personally will benefit, directly, or indirectly from his disclosure." *Dirks*, 463 U.S. at 662. In addition to pecuniary benefits, other benefits include reputational benefits and the intention to benefit a friend. *Id.* at 663-64.

287. *O'Hagan*, 521 U.S. at 658.

duty of trust or confidence owed to the source of the material nonpublic information, despite the fact that the source may not even be a buyer, seller, or market participant.

Moreover, it is questionable whether Rule 10b5-2 promotes investor confidence.²⁸⁸ Anger over insider trading may not actually undermine investor confidence in the securities market.²⁸⁹ Even though most people want insider trading to remain unlawful, these same individuals would likely engage in insider trading if the opportunity presented itself.²⁹⁰ If investors are willing to commit insider trading, it seems unlikely they have any confidence in the market in the first place.²⁹¹ The anger investors feel may actually be disguised as jealousy towards those with greater access to material nonpublic information.²⁹²

Furthermore, during the period when the Second Circuit developed the Misappropriation Theory, insider trading scandals rocked the securities industry.²⁹³ These scandals gained much publicity, which in turn made investors aware that insider trading was a common occurrence in the securities market.²⁹⁴ Nonetheless, amidst these scandals and the Theory's development, the stock market enjoyed one of its healthiest periods.²⁹⁵ In fact, the first year after passage of the 1934 Act until 1999 "has been marked by steady economic growth."²⁹⁶

However, this Note does not, in any way, advocate the deregulation of insider trading prohibitions. Given that investor confidence is

288. Bainbridge, *supra* note 14, at 1242.

289. *Id.*

290. *Id.*

291. *Id.*

292. *Id.*

293. *Id.* In May 1986, the SEC sued Dennis Levine, former managing director of Drexel Burnham Lambert, Inc., alleging he made \$12.6 million by trading in the securities of fifty-four issuing companies while in possession of material nonpublic information. H.R. REP. NO. 100-910, *supra* note 19, at 12. After pleading guilty to several federal violations including securities fraud, Levine disgorged \$11.6 million of his profits, paid \$362,000 in fines, and received a two-year prison sentence. *Id.*

The SEC's investigation of Levine resulted in Ivan Boesky's guilty plea and sentence of three years in prison. *Id.* The SEC alleged that Levine provided Boesky with material nonpublic information about companies prior to the announcement of their takeovers. *Id.* Boesky, through the companies he owned, made \$50 million using the information. *Id.* Boesky also disgorged \$50 million and paid a \$50 million penalty. *Id.*

On February 13, 1987, the SEC filed an injunction against Martin A. Siegel, one of the heads of mergers and acquisitions at Drexel Burnham Lambert, Inc., and a former Kidder, Peabody, and Co. executive. *Id.* The SEC alleged he disclosed confidential information about pending takeovers to Boesky. *Id.* Siegel disgorged \$9 million and agreed to being barred from the securities industry. *Id.*

On June 4, 1987, Kidder, Peabody & Co. agreed to disgorge more than \$13 million in profits and paid more than \$11 million in penalties. *Id.* After an administrative hearing, the company was ordered to obtain an outside consultant to review policies preventing securities violations and follow his recommendations. *Id.*

294. Bainbridge, *supra* note 14, at 1242.

295. *Id.* at 1243.

296. Ramirez, *supra* note 22, at 1066 n.35 (citing ROBERT J. GORDON, *MACROECONOMICS* 190-94 (5th ed. 1989); Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 389 (1964)).

apparently doing well, this Note merely asserts that the SEC need not continue the arbitrary and capricious path of detaching liability from harm, imposing liability on mere breaches of confidentiality, and imprisoning people and ending careers all for the sake of apparently promoting investor confidence. In the absence of an obvious investor confidence crisis, it is manifestly unfair to use criminal liability in such an erratic and ill-defined manner. After all, “confidence is dependent on human perception, and investors do not wander about with confidence blinkers on their foreheads.”²⁹⁷

D. Rule 10b5-2 Cannot Be Applied Criminally

Rule 10b5-2 is even more problematic in terms of its application as a criminal standard. For example, subsection (b)(1) of Rule 10b5-2 states that one of the situations that gives rise to a duty of trust or confidence is when there is an agreement to maintain information.²⁹⁸ However, it is unclear if it is sufficient that the agreement is oral or if it must be in writing.²⁹⁹ If the agreement can be oral, then it would seem that the accused could escape liability by claiming he never agreed to keep information confidential. If the agreement must be in writing, then this is essentially a contract between two parties to maintain information. Thus, if one of the parties used this information in violation of the agreement, it would be a breach of the contract. This produces the same problem for Rule 10b5-2 that *O’Hagan* and other Misappropriation Theory decisions suffer from, namely the SEC is criminalizing breaches of contract.

In Rule 10b5-2(b)(2), the SEC imports the concept of an implied contract with its language “such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects the recipient will maintain its confidentiality.”³⁰⁰ The SEC could have included the language “reckless in not knowing,” but it did not do so. As such, “not knowing or not reasonably knowing” is basically a negligence standard. However, a negligent breach of duty does not amount to fraud and is insufficient to impose a Rule 10b-5 violation.³⁰¹ There must be a showing of will-

297. *Id.*

298. 17 C.F.R. § 240.10b5-2(b)(1) (2001). Proposed Rule, *supra* note 262, at <http://www.sec.gov/rules/proposed/34-42259.htm>.

299. In *United States v. Chestman*, the Second Circuit held that there is no fiduciary relationship “absent a pre-existing fiduciary relation or an express agreement of confidentiality.” 947 F.2d 551, 571 (2d Cir. 1991). The SEC criticized the Second Circuit’s view in *Chestman* as too restrictive. Proposed Rule, *supra* note 262, at <http://www.sec.gov/rules/proposed/34-42259.htm>.

300. 17 C.F.R. § 240.10b5-2(b)(2).

301. Ramirez & Gilbert, *supra* note 5, at 206.

fulness, which is a “consciousness of wrongdoing,”³⁰² to impose criminal liability under Rule 10b-5.³⁰³

Moreover, this implied contract is an additional element that must be proved beyond a reasonable doubt.³⁰⁴ The first six elements were developed through case law:

(1) the defendant must trade based upon non-public material information (2) the defendant must owe a fiduciary duty to the source of the information (3) the fiduciary duty must be of sufficient scope to prohibit the use of the information by trading securities (4) the defendant must intentionally breach the fiduciary duty, (5) without disclosure to the source (6) resulting in cognizable damage to the source.³⁰⁵

Now, because of the implied contract requirement in Rule 10b5-2(b)(2), the prosecution must also prove a seventh element beyond a reasonable doubt:

[(7) T]he person communicating the material nonpublic information and the person to whom it is communicated have a history, practice, or pattern of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality . . .

If there is any reasonable doubt that the person communicating the information waived this expectation of confidentiality or did not objectively manifest a requirement of confidence, the defendant goes home.

Subsection (b)(2) of Rule 10b5-2 also uses a “facts and circumstances” test.³⁰⁶ This test considers both of the parties’ expectations in light of the relationship as a whole.³⁰⁷ The problem with this test is that it focuses on the history of the relationship. It does not cover a scenario where the information is obtained early in a relationship without any history to examine. It is not clear how the parties’ expectations will play a role in such a situation.

Subsection (b)(3) of Rule 10b5-2 is also problematic. Although the language claims to provide an affirmative defense, it impermissibly shifts the burden of production and persuasion to the defendant.³⁰⁸ The SEC imposes upon the defendant the burden of proving

302. *Id.* The requirement of willfulness means someone cannot accidentally become an insider trader.

303. *United States v. O’Hagan*, 521 U.S. 642, 666 (1997).

304. *In re Winship*, 397 U.S. 358, 364 (1970) (holding that the prosecution must prove beyond a reasonable doubt every fact necessary to constitute the crime charged).

305. *Ramirez & Gilbert*, *supra* note 5, at 207.

306. 17 C.F.R. § 240.10b5-2(b)(2) (2001).

307. *Id.*

308. “[C]ourts may be unwilling to apply [Rule 10b5-2] in the context of a criminal case [because it] would impermissibly shift the burden of persuasion to the defendant in a criminal trial.” John J. Kenney & Jerry M. Feeney, *SEC Proposes to Clarify Scope of Trading Prohibitions*, N.Y. L.J., Jan. 18, 2000, at 1.

“he or she neither knew nor reasonably should have known that the person who was the source of the information expected that [he or she] would keep the information confidential.”³⁰⁹

The Supreme Court has counseled that affirmative defenses violate the Due Process Clause if they “serve to negative any facts of the crime which the [prosecution] is to prove in order to convict [and are not a] separate issue on which the defendant is required to carry the burden of persuasion.”³¹⁰ The SEC’s so-called affirmative defense in subsection (b)(3) does negate a fact of the crime of insider trading under the Misappropriation Theory. The fact is that there was a situation that gave rise to a duty of trust or confidence. Furthermore, this apparent defense does not go to a separate issue. Whether a person knew or reasonably should have known his or her source of information expected confidentiality goes to the heart of the entire issue, which is whether there was a duty of trust or confidence. The SEC puts the onus on the defendant to show it was legal for him to trade. This is the precise reason why the defendant is being prosecuted in the first place. Forcing a defendant to prove his innocence is a clear violation of due process.

Additionally, in subsection (b)(3), the SEC claimed it only listed spouses, children, parents, and siblings because in its experience, most insider trading involved these relationships.³¹¹ Other than this statement, the SEC offers no explanation why only these relationships were included. In fact, the SEC specifically did not include stepparents, stepchildren, and domestic partners.³¹² The SEC failed to explain why the nature of these relationships would not likewise create a duty of trust or confidence. Does this subsection mean that homosexual partners are exempt from liability under the Misappropriation Theory? If so, under what rationale? How about unmarried parents who live in a state that does not recognize common law marriage? Would these families be exempt from the SEC’s new rule?

Rule 10b5-2 also leaves other significant issues of the Misappropriation Theory unresolved. A choice-of-law problem remains. The SEC stated that Rule 10b5-2 otherwise leaves the judicial opinions of the Misappropriation Theory intact.³¹³ Thus, the question of whether

309. 17 C.F.R. § 240.10b5-2(b)(3).

310. *Patterson v. New York*, 432 U.S. 197, 207 (1977). In *Patterson*, a defendant was on trial for second-degree murder. *Id.* New York had a law requiring the defendant to prove, by a preponderance of the evidence, that he suffered extreme emotional disturbance in order to reduce the crime. *Id.* The U.S. Supreme Court held that New York’s law did not violate the Due Process Clause because it “does not serve to negative any facts of the crime which the State is to prove in order to convict of murder [and] constitutes a separate issue on which the defendant is required to carry the burden of persuasion.” *Id.*

311. Final Rule, *supra* note 263, at <http://www.sec.gov/about/rules/final/33-7881.htm>.

312. *Id.* at <http://www.sec.gov/about/rules/final/33-7881.htm>.

313. See the Preliminary Note to § 240.10b5-2. 17 C.F.R. § 240.10b5-2.

federal law or state law is the source of the fiduciary duty analysis still remains unanswered. Additionally, the ability of the source of the information to waive liability for a suspected misappropriator seems to remain intact. Similarly, despite Rule 10b5-2, disclosure to the source of the intent to trade or consent from the source relieves a person from criminal liability. Therefore, this new rule keeps the keys to the jailhouse door in the source's hands.

E. *What Can The SEC Do?*

The federal circuits, the U.S. Supreme Court, and Congress have all had their turn to explain what types of relationships involve fiduciary duties and are subject to criminal liability under the Misappropriation Theory. These entities have either failed to do so or not tried at all. Now, it is the SEC's turn to step up and fill the void. The SEC's approach to defining fiduciary duties could be broken down into four categories: (1) People who regularly deal with confidential information; (2) People who do not regularly deal with confidential information; (3) People to whom the term fiduciary arguably does not apply; and (4) People who are not fiduciaries at all.³¹⁴

The SEC could articulate a rule prohibiting certain professionals who regularly use confidential information that is material to the securities market from trading on stocks that are related to that inside information.³¹⁵ This category of people would include professionals such as stockbrokers, attorneys, accountants, corporate partners, shareholders, and investment bankers.³¹⁶ Alternatively, the SEC could require that such individuals disclose not only that they will use this information, but also the number of shares the professional will buy or sell.³¹⁷ The SEC could even require that the professional fill out a form describing the trade and the relationship.³¹⁸ The professional could then be required to file the form with the fiduciary before the trade and with the SEC after the trade.³¹⁹

For those who do not regularly use confidential information, the SEC could require merely that they give oral notice of their intent to trade to their principal.³²⁰ Such individuals may include physicians, teachers, and clergy.³²¹ For minor trades that do not affect security

314. Painter et al., *supra* note 4, at 213-17.

315. *Id.* at 213.

316. *Id.*

317. *Id.*

318. *Id.*

319. *Id.*

320. *Id.*

321. *Id.*

prices, the SEC could even allow these individuals to not disclose the information until after the trade.³²²

There are people who arguably cannot be categorized as having fiduciary duties.³²³ Identifying these people may involve fine distinctions.³²⁴ For instance, such individuals may include a janitor employed by a financial printer but not a janitor who works at an office building. It could include a receptionist at a law firm helping someone with their coat but not a coat checker at a restaurant.³²⁵ Other individuals may fall into this category as well.³²⁶ These people may include overnight delivery workers, messengers, independent contractors, limousine drivers, and shoe shiners.³²⁷

A specific and detailed rule from the SEC would help clarify these distinctions.³²⁸ For example, the SEC could rule that those who work outside of places that regularly deal with confidential information are not susceptible to the Misappropriation Theory unless they sign a confidentiality agreement required by their employer.³²⁹ Such a rule would help those who are not sure whether they have a fiduciary relationship.³³⁰ For example, such a ruling would help a limousine driver who is under contract with a law firm know whether it is legal to trade on information overheard from backseat conversations.³³¹ Likewise, such a rule would educate the travel agency employee about whether keeping the identity of a deceased IBM executive confidential means not using the fact that he died to trade on stocks.

IV. CONCLUSION

Prosecutions for insider trading continue to thrive. Moreover, the SEC appears poised to channel prosecutions towards family members, friends, and other people who have no real connection to the securities market. The SEC's souped-up Misappropriation Theory targets these individuals. Unfortunately, this chaotic form of criminal liability continues to leave avid participants and disinterested bystanders of the securities markets wondering whether they have a duty of trust or confidence for the purposes of the Misappropriation Theory and to whom. The SEC must act so that people are not swept up by this Theory's mystifying scope and imprisoned while they speculate.

322. *Id.* at 214.

323. *Id.*

324. *Id.*

325. *Id.*

326. *Id.*

327. *Id.*

328. *Id.*

329. *Id.* at 214-15.

330. *Id.* at 215.

331. *Id.*

A clear definition of what duties trigger criminal liability under the Theory would not only enlighten the defendants the SEC pursues but benefit the investing public as a whole.