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Corporate Law: Misappropriation Theory of Liability Upheld for Rule 10B-5 Criminal Convictions

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CASE COMMENT

CORPORATE LAW: MISAPPROPRIATION THEORY OF LIABILITY UPHELD FOR RULE 10B-5 CRIMINAL CONVICTIONS

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

*Stefan Rubin***

Respondent was charged with fifty-seven counts of mail fraud, securities fraud, fraudulent trading in connection with a tender offer, and money laundering.[1] The securities fraud charges were based on section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder.[2] As a partner in a law firm, Respondent

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** This Case Comment is dedicated to my wonderful parents, without whose love and support this never would have been possible.

1. *See* United States v. O'Hagan, 117 S. Ct. 2199, 2205 (1997).

2. *See id.* at 2205. Section 10(b) provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> . . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (1994). Under power granted by Congress in § 10(b), the SEC promulgated Rule 10b-5, which provides in relevant part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> (a) To employ any device, scheme, or artifice to defraud, . . . or
> (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 (1996).

learned that one of his firm's clients was proposing a tender offer[3] to acquire a company.[4] Although Respondent did not work directly with the client, he learned of nonpublic information regarding the acquisition.[5] News of the acquisition had not yet been released to the public when Respondent began purchasing call options[6] and common stock in the proposed target company.[7] After the acquisition was announced to the public,[8] Respondent liquidated his securities for a profit of $4.3 million.[9] The Securities and Exchange Commission (SEC) initiated an investigation and charged Respondent with securities fraud under a misappropriation theory of liability.[10]

At trial, Respondent was convicted on all counts.[11] On appeal to the Eighth Circuit, Respondent contested that the misappropriation theory was an impermissible theory of liability under both section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and SEC Rule 10b-5.[12] Accepting this argument,[13] the Eighth Circuit reversed the district court's opinion.[14] After granting certiorari, the United States Supreme Court reversed and HELD, the misappropriation theory is a valid theory

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3. A tender offer is "a form of acquisition in which the acquiring corporation goes directly to the shareholders of the target corporation and asks them to 'tender' their shares in exchange for whatever the acquiring corporation is willing to offer." LARRY D. SODERQUIST ET AL., CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 821 (4th ed. 1997).

4. *See O'Hagan*, 117 S. Ct. at 2205.

5. *See* SEC v. O'Hagan, 901 F. Supp. 1461, 1463 (D. Minn. 1995), *rev'd sub nom.*, United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

6. A call option is a financial instrument which provides its owner the right to purchase a specific number of shares of stock at a set price within a specified time period. After the time period ends, the option expires and the owner may no longer exercise the right to purchase shares. *See* United States v. O'Hagan, 92 F.3d 613, 614 n.1 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997).

7. *See O'Hagan*, 117 S. Ct. at 2205. When the tender offer was publicly announced, Respondent already owned 2500 unexpired options (each representing the right to purchase 100 shares) and 5000 shares of common stock of the target company. *See id.*

8. Several courts have found that the announcement of the target company's identity in a proposed tender offer usually causes that company's stock price to increase. *See, e.g.*, SEC v. Maio, 51 F.3d 623, 628 n.3 (7th Cir. 1995) (noting that "[w]hen a tender offer is announced, usually the price of the target company rises and the price of the offeror falls or remains the same"); SEC v. Materia, 745 F.2d 197, 199 (2d Cir. 1984) (stating that "even a hint of an upcoming tender offer may send the price of the target company's stock soaring").

9. *See O'Hagan*, 117 S. Ct. at 2205. When the tender offer was announced, the stock price of the target company rose approximately 50%, from $39 per share to nearly $60 per share. *See id.*

10. *See id.*

11. *See id.*

12. *See O'Hagan*, 92 F.3d at 615.

13. *See id.* at 622.

14. *See id.* at 628.

of liability under section 10(b) of the Exchange Act and SEC Rule 10b-5.[15]

The primary purpose of section 10(b) and Rule 10b-5 is to promote market integrity and investor confidence.[16] Section 10(b) prohibits using any manipulative or deceptive device, or violating any SEC rule promulgated in furtherance of section 10(b), "in connection with" a securities transaction.[17] Under powers granted by Congress to promote section 10(b), the SEC enacted Rule 10b-5 to further protect the integrity of the market.[18] Similarly, Rule 10b-5 prohibits committing any "fraud or deceit upon any person, in connection with the purchase or sale of any security."[19] Rule 10b-5 violations give rise to both civil and criminal liability,[20] and the misappropriation theory of Rule 10b-5 liability has been supported in both the criminal and civil enforcement actions.[21]

Traditionally, only insiders of the target company in a proposed tender offer could be charged with Rule 10b-5 violations.[22] Gradually, the SEC also began to charge outsiders with Rule 10b-5 violations.[23]

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15. *See O'Hagan*, 117 S. Ct. at 2213-14.

16. *See generally* 15 U.S.C. § 78j(b) (1994); *O'Hagan*, 117 S. Ct. at 2210; Brief of Amicus Curiae Association for Investment Management and Research in Support of Petitioner at 3-10, United States v. O'Hagan, 117 S. Ct. 2199 (1997) (No. 96-842) [hereinafter AIMR Brief]. The stability of our financial market is premised on the notion that all investors begin on equal footing. *See O'Hagan*, 117 S. Ct. at 2210. While complete parity of information is impossible, "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law." *See id.*

17. *See* 15 U.S.C. § 78j(b) (1994); *supra* note 2.

18. *See* 15 U.S.C. § 78j(b) (1994) (authorizing the SEC to enact rules "for the protection of investors").

19. 17 C.F.R. § 240.10b-5(c); *supra* note 2.

20. *See* 15 U.S.C. §§ 78u, 78ff (1997); *see also O'Hagan*, 117 S. Ct. at 2206 (stating that "criminal liability under § 10(b) may be predicated on the misappropriation theory"); United States v. Newman, 664 F.2d 12, 16 (2d Cir. 1981) (stating that "section 10(b) was written as both a regulatory and criminal piece of legislation"), *cert. denied*, 464 U.S. 863 (1983).

21. *See O'Hagan*, 117 S. Ct. at 2206; *see also Materia*, 745 F.2d at 201 (upholding injunction and penalty in SEC enforcement action for violations of Rule 10b-5 under the misappropriation theory); *Newman*, 664 F.2d at 16, 19 (explaining that a Rule 10b-5 criminal prosecution can be based upon a misappropriation theory of liability).

22. *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961) (stating that an affirmative duty to disclose nonpublic information before trading on it has traditionally been imposed on corporate insiders such as officers, directors, and majority shareholders); *see also* General Time Corp. v. Talley Indus., Inc., 403 F.2d 159, 164 (2d Cir. 1968) (stating that "[w]e know of no rule of law . . . that a purchaser of stock, who was not an 'insider' and had no fiduciary relation to a prospective seller, had any obligation to reveal" nonpublic information regarding the securities transaction).

23. *See, e.g.*, Chiarella v. United States, 445 U.S. 222 (1980); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984); United States v. Newman, 664 F.2d 12 (2d Cir. 1981).

One of the earliest decisions addressing Rule 10b-5 liability for outsiders of the target company was *Chiarella v. United States*.[24] In that case, the defendant worked for a financial printer.[25] While at work, he deduced from partially blank documents the identities of the target companies of several proposed tender offers.[26] On the basis of this nonpublic information, he purchased stock in the target companies.[27] The SEC charged the defendant with violating section 10(b) and Rule 10b-5 by purchasing securities in the target companies without disclosing the nonpublic information.[28] The district court convicted the defendant on all counts and the Second Circuit affirmed his conviction.[29]

The Supreme Court reversed, holding that the defendant did not commit the fraud necessary to violate Rule 10b-5.[30] The Court reasoned that the defendant's nondisclosure of the nonpublic information could only constitute a fraud if the defendant first had a duty or obligation to disclose the information.[31] The Court held that only insiders and fiduciaries of the target company owed such a duty to the company and its stockholders.[32] Because the defendant was neither an insider nor a fiduciary of the target company, he did not owe a duty to the company or its stockholders.[33] The Court further reasoned that it could only affirm the defendant's conviction if it recognized a broad duty among all market participants to either disclose or abstain from

24. 445 U.S. 222 (1980).

25. *See Chiarella*, 445 U.S. at 224.

26. *See id.* A company's stock price is sensitive to news of a proposed corporate takeover. *See Materia*, 745 F.2d at 199. Therefore, the identities of the companies involved are usually omitted from the preliminary drafts of the merger or acquisition documents until as late as possible. *See id.*; *see also Chiarella*, 445 U.S. at 224 (recognizing that the identities of the firms are usually concealed until the final printing).

27. *See Chiarella*, 445 U.S. at 224.

28. *See id.* at 225.

29. *See id.*

30. *See id.* at 225, 232.

31. *See id.* at 228, 231.

32. *See id.* at 229; *see also Cady, Roberts & Co.*, 40 S.E.C. at 911 (recognizing that insiders with nonpublic information are under a duty to disclose the information before they trade on it). This is known as the classical theory of Rule 10b-5 liability. *See O'Hagan*, 117 S. Ct. at 2207. The classical theory applies to both insiders, such as those who work directly for the target company, and temporary insiders, such as accountants, lawyers, etc. who have a fiduciary relationship with the target company. *See id.*; *see also* Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983) (noting that certain corporate outsiders, such as accountants and lawyers, may become fiduciaries of a company if nonpublic corporate information is shared with them as a result of their confidential relationship to the company).

33. *See Chiarella*, 445 U.S. at 231-33.

trading on nonpublic information.[34] Based on the language and the legislative history of section 10(b), however, the Court found no evidence of such a broad duty among market participants.[35] Under this narrow interpretation of section 10(b), the defendant because he could not be guilty of Rule 10b-5 fraud for not disclosing the information,[36] did not have a duty to disclose the information to the company or its stockholders.

The SEC alternatively argued that the defendant was guilty of violating Rule 10b-5 because he misappropriated confidential information entrusted to his employer by the target company.[37] Under this theory of liability, the duty breached which constitutes the fraud is the defendant's duty of confidentiality to his employer.[38] The Court dismissed this argument and refused to assess the validity of this misappropriation theory because it was not originally submitted to the jury.[39]

However, Chief Justice Burger espoused an even larger misappropriation theory of Rule 10b-5 liability in his strongly-worded dissent to *Chiarella*.[40] According to Chief Justice Burger's broad interpretation of Rule 10b-5, any person who fraudulently and unlawfully misappropriates nonpublic information owes a duty to all other market participants to either "disclose that information or to refrain from trading" on it.[41] By using his employer's nonpublic information for private, personal gain, the defendant breached his duty of confidentiality to his employer and thus owed an absolute duty to either disclose the information or refrain from trading on it.[42] Chief Justice Burger believed that, under the misappropriation theory, the defendant was guilty of violating Rule 10b-5 by not disclosing the nonpublic information.[43] This marked the birth of the misappropriation theory of Rule 10b-5 criminal liability.

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34. *See id.* at 233. This bright line rule became known as the "disclose or refrain" rule.

35. *See id.*

36. *See id.* at 231.

37. *See id.* at 235.

38. *See id.* at 235-36.

39. *See id.*

40. *See id.* at 243-44 (Burger, C.J., dissenting).

41. *Id.* at 240 (Burger, C.J., dissenting). Chief Justice Burger stated that he would read the language of § 10(b) and Rule 10b-5 as requiring that "a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading." *Id.*

42. *See id.* at 240, 244 (Burger, C.J., dissenting).

43. *See id.* at 245 (Burger, C.J., dissenting).

After Chief Justice Burger introduced the misappropriation theory in his dissent to *Chiarella*, the SEC took note and began basing Rule 10b-5 charges solely upon the misappropriation theory.[44] *SEC v. Materia* was one of the first cases where the federal courts were forced to rule on the validity of the misappropriation theory.[45] In *Materia*, the Second Circuit faced nearly the same factual situation as it had in *Chiarella*.[46] The defendant worked for a financial printer and deduced the identities of the target companies of several proposed acquisitions.[47] Based on this information, he then purchased securities in the target companies before the news was released to the public.[48] The SEC charged the defendant with violating Rule 10b-5 under the misappropriation theory of liability, claiming that he misappropriated his employer's information by using it to purchase securities for personal, financial gain.[49] Thus, in this case the misappropriation theory of liability was properly submitted for judicial consideration.[50]

The district court held that the defendant had violated section 10(b) and Rule 10b-5[51] and the Second Circuit affirmed, wholly embracing the misappropriation theory as suggested in Chief Justice Burger's dissent in *Chiarella*.[52] The court stated that the legislative history of the Exchange Act indicated that section 10(b) "was intended to be broad in scope."[53] Under a broad interpretation of Rule 10b-5, any fraud in connection with the trading of securities is enough to warrant Rule 10b-5 liability.[54] In the wake of the Supreme Court's recent reversal of *Chiarella*, the Second Circuit distinguished *Materia* on the sole ground that, in *Materia,* the misappropriation theory was properly submitted for consideration.[55] The court then pointed out that in *Chiarella*, the Supreme Court intentionally left the validity of the misappropriation

44. *See, e.g., Materia*, 745 F.2d at 199-200; *Newman*, 664 F.2d at 15-16.

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

46. *See id.* at 199.

47. *See id.*; *see also supra* text accompanying note 26.

48. *See Materia*, 745 F.2d at 199.

49. *See id.* at 199-200. The SEC brought an enforcement action, rather than criminal charges, against the defendant. *See id.* The SEC sought a permanent injunction to prevent future violations, as well as an order requiring that the defendant turn over all profits from illegal trading to the SEC. *See id.*

50. *Compare id.* at 200 *with supra* text accompanying note 39.

51. *See Materia*, 745 F.2d at 200.

52. *See id.* at 203.

53. *Id.* at 201.

54. *See id.*

55. *See id.* at 203. The court explained that the misappropriation theory was not rejected by the Supreme Court in *Chiarella*. *See id.* The theory simply was not considered because it had not been originally submitted to the jury. *See id.*

theory to be decided at another time.[56] Although the Supreme Court left this issue unresolved,[57] the Second Circuit upheld the district court's judgment under this new misappropriation theory of liability.[58]

However, other circuits have been reluctant to uphold the misappropriation theory of Rule 10b-5 liability.[59] For instance, in *United States v. Bryan*, the Fourth Circuit rejected the SEC's use of the misappropriation theory in Rule 10b-5 actions.[60] In *Bryan*, the defendant was the director of the West Virginia Lottery.[61] When the lottery decided to expand by offering video lottery terminals, it accepted bids from various gaming companies.[62] The defendant then purchased stock in several of the bidding companies and rigged the selection process to ensure that one of the companies in which he owned stock would be awarded the contract.[63] Once the lottery selected a contractor, but before the news was released to the public, the defendant purchased additional stock in that company.[64] The SEC charged the defendant with violating Rule 10b-5 under the misappropriation theory of liability,[65] claiming that he misappropriated nonpublic information from his employer and then used the information to purchase securities.[66] The district court convicted him under the misappropriation theory.[67]

On appeal, the Fourth Circuit rejected the misappropriation theory of liability and reversed the defendant's conviction.[68] In reaching this conclusion, the court carefully construed the precise language of section 10(b) and Rule 10b-5.[69] It noted that because Rule 10b-5 was promulgated in furtherance of section 10(b), it cannot be construed any more broadly than section 10(b).[70] Because section 10(b) uses the word

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56. *See id.* (quoting *Chiarella*, 445 U.S. at 238 (Stevens, J., concurring)).

57. *See id.*

58. *See id.* at 204.

59. *See, e.g.*, United States v. O'Hagan, 92 F.3d 612, 622 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997); United States v. Bryan, 58 F.3d 933, 944 (4th Cir. 1995), *overruled by* United States v. O'Hagan, 117 S. Ct. 2199 (1997).

60. *See Bryan*, 58 F.3d at 944.

61. *See id.* at 936.

62. *See id.* at 938.

63. *See id.* at 938-39.

64. *See id.* at 939.

65. *See id.* at 943.

66. *See id.* at 939.

67. *See id.* at 936, 939.

68. *See id.* at 944.

69. *See id.* at 945-46.

70. *See id.* at 949 n.15; *see also O'Hagan*, 117 S. Ct. at 2217 n.18 (noting that "Rule 10b-5 may proscribe only conduct that § 10(b) prohibits"); Ernst & Ernst v. Hochfelder, 425

"deception," any valid theory of liability under Rule 10b-5 must further this deception requirement.[71] The Fourth Circuit reasoned that the misappropriation theory allows liability when nonpublic information is misappropriated in breach of a fiduciary duty, without requiring any actual deception.[72] Because the misappropriation theory "does not even require deception,"[73] the court stated that the theory is broader than section 10(b) and therefore cannot be a valid theory of Rule 10b-5 liability.[74] This set the stage for the Supreme Court to reconcile the conflicting views among the circuit courts.[75]

In the instant case, the Supreme Court upheld the misappropriation theory as a valid theory of liability under section 10(b) and Rule 10b-5.[76] The instant Court held that the misappropriation theory satisfied Rule 10b-5's requirement that the "deception" be "in connection with" a securities transaction.[77] The Court found that the "deception" element was satisfied because misappropriating an employer's information for private, personal gain defrauds the employer who entrusted the employee with confidential information.[78] The Court found that the "in connection with" element was satisfied because the Rule 10b-5 liability arose only when the misappropriator actually traded on the nonpublic information.[79] Thus, the fraud was not consummated until the decep-

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U.S. 185, 214 (1976) (stating that the scope of SEC Rule 10b-5 "cannot exceed the power granted the [SEC] by Congress under § 10(b)").

71. *See Bryan*, 58 F.3d at 946, 949.

72. *See id.*

73. *Id.*

74. *See id.* at 944, 949.

75. *See O'Hagan*, 117 S. Ct. at 2206. The Second, Seventh, and Ninth Circuits have upheld the misappropriation theory of Rule 10b-5 liability, while the Fourth and Eighth Circuits have been reluctant to uphold the theory. *See, e.g.*, SEC v. Maio, 51 F.3d 623 (7th Cir. 1995); SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991); SEC v. Clark, 915 F.2d 439 (9th Cir. 1990); SEC v. Materia, 745 F.2d 197 (2d Cir. 1984); United States v. Newman, 664 F.2d 12 (2d Cir. 1981). *But see, e.g.*, United States v. O'Hagan, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 117 S. Ct. 2199 (1997); United States v. Bryan, 58 F.3d 933 (4th Cir. 1995), *overruled by* United States v. O'Hagan, 117 S. Ct. 2199 (1997). Since *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court has only considered the misappropriation theory one other time, in *Carpenter v. United States*, 484 U.S. 19 (1987). *See O'Hagan*, 117 S. Ct. at 2206 n.4. In that case, the Justices were evenly split on the issue of whether the securities fraud charges based upon the misappropriation theory of liability should be upheld. *See id.*

76. *See O'Hagan*, 117 S. Ct. at 2213-14.

77. *See id.* at 2208.

78. *See id.*

79. *See id.* at 2209. It was not a violation for Respondent to possess the nonpublic information. *See id.* The violation was consummated when he traded securities based upon the nonpublic information. *See id.*

tion and misappropriation were used to purchase or sell securities.[80] Under this broad interpretation of section 10(b) and Rule 10b-5, almost any fraud in connection with a securities transaction will satisfy the fraud requirement.[81] The fraud does not have to be against the company or its stockholders.[82]

The instant Court also looked at the legislative history and policy behind section 10(b) and Rule 10b-5.[83] It recognized that the Exchange Act was designed "to insure honest securities markets and thereby promote investor confidence."[84] Because the misappropriation theory protects the integrity of the market, by preventing outsiders from using nonpublic information in connection with securities transactions, the Court reasoned that the misappropriation theory lies within the broad purview of section 10(b) and Rule 10b-5.[85] Finally, the Court stated that in promoting market integrity, "it makes scant sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder."[86] Thus, the instant Court held that section 10(b) was intended to be read broadly, allowing liability for any fraud in connection with the trading of securities.[87]

Justice Scalia, in a brief dissent, focused purely on the principle of lenity applied when interpreting criminal statutes.[88] According to the principle of lenity, when a court faces an ambiguous criminal statute, it should interpret the statute so that the result is most favorable to the defendant.[89] Thus, Justice Scalia believed that the principle of lenity should have guided the Court's statutory construction of section 10(b) and Rule 10b-5 to be as narrow as possible.[90] Accordingly, Justice

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80. *See id.*

81. *See id.* at 2209-10.

82. *See id.*

83. *See id.* at 2207-10.

84. *See id.* at 2210 (citing 45 Fed. Reg. 60412 (1980)). The Court stated that "[a]lthough informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law." *See id. See generally* AIMR Brief, *supra* note 16.

85. *See O'Hagan*, 117 S. Ct. at 2207-08.

86. *Id.* at 2210-11.

87. *See id.* at 2211.

88. *See id.* at 2220 (Scalia, J., concurring in part and dissenting in part). Because there was obvious ambiguity in the interpretation of § 10(b) and Rule 10b-5, as evidenced by the dichotomy of results among the circuit courts, the principle of lenity should have guided the Court in interpreting the criminal statute to be as narrow as possible and more favorable to the defendant. *See* PAUL H. ROBINSON, FUNDAMENTALS OF CRIMINAL LAW 135 (2d ed. 1995).

89. *See* ROBINSON, *supra* note 88.

90. *See O'Hagan*, 117 S. Ct. at 2220 (Scalia, J., concurring in part and dissenting in part).

Scalia narrowly read the language of section 10(b) and Rule 10b-5 as requiring that the "manipulation" or "deception" be of the other party to the securities transaction, and not just of any market participant.[91] Under this narrow interpretation of section 10(b) and Rule 10b-5, the misappropriation theory would be an invalid theory of liability.[92]

The instant decision affirms the misappropriation theory as a valid theory of liability under Rule 10b-5.[93] Since the misappropriation theory was first broached in Chief Justice Burger's dissent in *Chiarella* over seventeen years ago, the federal circuit courts have struggled to understand the kinds of actions that fall within the Rule 10b-5 prohibition under the theory.[94] The instant Court now has made clear that a breach of any fiduciary duty in connection with the exchange of securities violates Rule 10b-5.[95]

The primary importance of the instant decision is that it expands Rule 10b-5 liability to include corporate outsiders as well as insiders.[96] While the SEC still will have to prove that the outsider breached some fiduciary duty, this should not pose a problem in most situations because confidential information is usually only obtained by reason of a fiduciary relationship.[97] Subjecting both insiders and outsiders to Rule 10b-5 liability should substantially reduce securities trading based on nonpublic information.[98] This, in turn, should promote market integrity and further the policy behind section 10(b) and Rule 10b-5.[99]

Although the instant Court relied upon a broad interpretation of section 10(b) and Rule 10b-5, it recognized that the misappropriation theory of outsider liability currently upheld is still not as broad as Chief Justice Burger's original theory set forth in his dissent in *Chiarella*.[100]

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91. *See id.* (Scalia, J., concurring in part and dissenting in part).

92. *See id.* (Scalia, J., concurring in part and dissenting in part).

93. *See id.* at 2213-14.

94. *See supra* note 75.

95. *See O'Hagan*, 117 S. Ct. at 2207.

96. *See id.* The misappropriation theory of Rule 10b-5 liability applies only to corporate outsiders. *See id.* Until now, some circuits have allowed Rule 10b-5 liability under the misappropriation theory while others have not. *See supra* note 75. In the circuits that failed to recognize the misappropriation theory, outsiders could only be charged with Rule 10b-5 violations if they were, in essence, temporary insiders or fiduciaries of the target company. *See O'Hagan*, 117 S. Ct. at 2207; *Dirks*, 463 U.S. at 655 n.14.

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

98. *See id.* at 2207-08.

99. *See id.*

100. *See id.* at 2208 n.6. The Court noted that Chief Justice Burger "advanced a broader reading of § 10(b) and Rule 10b-5" where "the disclosure obligation . . . ran to those with whom the misappropriator trades." *Id.* (citing *Chiarella*, 445 U.S. at 240 (Burger, C.J., dissenting)).

Chief Justice Burger espoused an absolute duty to "disclose or refrain."[101] Under that view, the misappropriator simply cannot trade securities while in possession of nonpublic information.[102] The misappropriator must refrain from trading until the information is disclosed to the public.[103]

However, the instant Court noted that under the theory currently upheld, the misappropriator only has a duty to disclose his intent to trade on the basis of the nonpublic information to the sources of the information.[104] Because the misappropriator only owes a fiduciary duty to the sources of the information, the only possible Rule 10b-5 violation is if the misappropriator breaches his fiduciary duty to disclose to those sources.[105] Thus, in the instant case, Respondent had a duty to disclose his intent to trade securities to both his firm and his firm's client.[106] If the misappropriator discloses his proposed trading to the sources of the information, then he is not deceiving them and is not guilty of the fraud necessary for Rule 10b-5 liability.[107] The Court stressed, however, that disclosure only precludes the misappropriator from section 10(b) and Rule 10b-5 liability.[108] If the misappropriator trades securities based upon the nonpublic information, even if he disclosed his intent to trade, he still may be liable under state law for breach of a duty of loyalty.[109]

Similarly, the Court recognized another inherent limitation of the misappropriation theory currently upheld.[110] If the source of the information authorizes the misappropriator to trade on the nonpublic information, then the misappropriator is not defrauding the source and will not satisfy Rule 10b-5's fraud requirement.[111] For instance, in the instant case, if the Respondent's firm and its client specifically authorized all employees to use the nonpublic information for trading purposes, then the Respondent would not be guilty of violating Rule

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

102. *See id.* at 243-45 (Burger, C.J., dissenting).

103. *See id.* (Burger, C.J., dissenting)

104. *See O'Hagan*, 117 S. Ct. at 2208 n.6 (noting that "the disclosure obligation runs to the source of the information").

105. *See id.*

106. *See id.*

107. *See id.* at 2209. The Court stressed that "[d]eception through nondisclosure is central to the [misappropriation] theory. . . ." *Id.* at 2208. Therefore, disclosure precludes liability under the theory because there cannot be deception if the information is first disclosed. *See id.* at 2209.

108. *See id.* at 2209.

109. *See id.*

110. *See id.* at 2211 n.9.

111. *See id.*

10b-5.[112] If the Respondent were allowed to use the information, then he would not be deceiving or defrauding the sources of the information by using the information in connection with securities transactions.[113]

Although the misappropriation theory is designed to prevent outsiders from trading on nonpublic information,[114] it does not fully achieve this goal.[115] Under the current misappropriation theory, the misappropriator must breach some fiduciary duty to the source of the information in order to be liable under Rule 10b-5.[116] However, if the misappropriator does not owe any fiduciary duty to the source of the nonpublic information, then the misappropriator cannot be guilty under the misappropriation theory of Rule 10b-5 liability.[117] For instance, suppose a waiter overhears two corporate directors secretly discussing their company's recent oil discovery during dinner and then, based on this information, purchases securities in the company.[118] Under current law, the waiter, an outsider, will not be guilty of violating the misappropriation theory because he does not owe a fiduciary duty to either the two directors or to the restaurant.[119] The outsider can legally buy or sell securities in the company.[120] This permissible investment is clearly contrary to the market integrity purposes behind section 10(b) and Rule 10b-5.[121]

Another critical downfall of the instant decision was suggested by Justice Scalia's dissent.[122] Specifically, the instant case involves the criminal application of section 10(b) and Rule 10b-5.[123] In holding that the misappropriation theory is valid under Rule 10b-5, the Court relied on a broad construction of section 10(b) and Rule 10b-5.[124] This approach is contrary to the judicial system's usual approach towards interpreting ambiguous criminal statutes.[125] While the subjective merits of the misappropriation theory may be argued in the alternative, the

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112. *See id.*

113. *See id.* However, when dealing with tender offers, principals who authorize such trading may then be liable themselves under other sections of the Exchange Act. *See id.*

114. *See id.* at 2207.

115. *See* Thomas Lee Hazen, *"Insider Trading" Under Rule 10b-5, in* AMERICAN LAW INSTITUTE—AMERICAN BAR ASSOCIATION CONTINUING LEGAL EDUCATION 377, 382 (1997).

116. *See O'Hagan*, 117 S. Ct. at 2207.

117. *See id.*

118. *See* Hazen, *supra* note 115.

119. *See id.*

120. *See id.*

121. *See O'Hagan*, 117 S. Ct. at 2210.

122. *See id.* at 2220 (Scalia, J., concurring in part and dissenting in part).

123. *See id.* at 2206.

124. *See id.* at 2210.

125. *See* ROBINSON, *supra* note 88.

objective statutory construction procedures should not have been overlooked.[126] In the instant case, because the misappropriation theory is being applied in a criminal context, Rule 10b-5 should have been construed as narrowly as possible, requiring that the requisite fraud element be met only by a breach of a duty to the other party of the securities transaction, and not just a breach of any fiduciary duty at all.[127]

Although the instant decision is clearly a victory for the SEC, it is by no means a panacea to the market integrity problem created by investors trading on nonpublic information. Even though the misappropriation theory protects market integrity, there still will be situations where outsiders will be able to use nonpublic information in connection with securities transactions.[128] Furthermore, there will never be a complete parity of information among market participants.[129] As long as this is true, investing in the market will continue to be riskier than the drafters of section 10(b) and Rule 10b-5 intended.

126. *See O'Hagan*, 117 S. Ct. at 2220 (Scalia, J., concurring in part and dissenting in part).

127. *See id.* (Scalia, J., concurring in part and dissenting in part). Justice Scalia explains that the majority's interpretation of § 10(b) and Rule 10b-5 "does not seem to accord with the principle of lenity we apply to criminal statutes. . . ." *Id.*

128. *See, e.g., supra* text accompanying notes 118-20.

129. *See O'Hagan*, 117 S. Ct. at 2210. The Court recognized that "informational disparity is inevitable in the securities markets." *Id. See generally* AIMR Brief, *supra* note 16.