The Misappropriation Theory and Securities Fraud Liability; Its Days Are Numbered

Mark A. Dessi
THE MISAPPROPRIATION THEORY AND SECURITIES FRAUD LIABILITY; ITS DAYS ARE NUMBERED*

INTRODUCTION

Article I, Section 8 of the United States Constitution empowers Congress to regulate the "channels and instrumentalities" of interstate commerce, as well as activities which possess a substantial economic relation to interstate commerce. This Congressional power is valid, as long as it does not substantially infringe upon the sovereignty of the states.

* "For PaPa"

1 See U.S. CONST. art. I, § 8, cl. 18. The Federal Constitution provides in relevant part:

The Congress shall have power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; Cl. 18 To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers, and all other Powers vested by this Constitution in the Government of the United States, or in any Department or Officer thereof.

2 See Champion v. Ames, 188 U.S. 321, 323 (1903) (prohibiting lottery ticket transportation across state borders is within Congressional power and not within state's police powers); Paul v. Virginia, 75 U.S. 168, 170 (1868) (ruling that insurance policies do not constitute interstate commerce). See generally Nathan v. Louisiana, 49 U.S. 73, 73 (1850) (holding Bills of Exchange are not interstate commerce).

3 See Jones v. SEC, 298 U.S. 1, 10 (1936) (articulating constitutional objections to SEC Acts); Garfield v. United States ex rel. Goldsby, 211 U.S. 249, 262 (1908) (discussing how there is no room in our governmental system for arbitrary imposition of power); United States v. Detroit & Lumber Co., 200 U.S. 321, 338 (1906) (documenting delineation between courts and departmental administration offices); Noble v. Union River Logging R.R. Co., 147 U.S. 165, 171 (1893) (issuing injunction to prevent public officers from unlawfully assuming power over interstate property).

4 See Austin v. New Hampshire, 420 U.S. 656, 657 (1975) (documenting availability of Privileges and Immunities and Commerce Clause together in Articles of Confederation); Paul v. Virginia, 75 U.S. 168, 170 (1868) (stating, "Indeed without some provision of some kind removing from the citizens of each state the disabilities of alienage in the other states, and giving them equality of privilege with those states...[i]t would not have constituted the union which now exists" (quoting Baldwin v. Fish & Game Comm'n of Montana, 436 U.S. 377, 380 (1978))); Ward v. Maryland, 79 U.S. 418, 422 (1870) (explaining how separation of Privilege and Immunities Clause and Commerce Clause was done in anticipation of potential of narrow reading); cf. Bank of Augusta v. Earle, 38 U.S. 519, 579 (1839) (documenting state authority with respect to corporate restructur-
Congress exercised its interstate commerce authority by empowering the Securities and Exchange Commission ("SEC") with rule-making authority after the stock market crash of 1929.\(^5\) In order to curtail rampant fraudulent investing practices and protect the securities market, it was imperative for the SEC to enact regulatory provisions.\(^6\) The SEC, in developing the Securities Exchange Act of 1934 ("'34 Act"), has taken an aggressive stance in combating fraudulent investing practices.\(^7\) For example, pursuant to its rule-making authority under Section 10(b) of the '34 Act, the SEC promulgated Rule 10b-5 as the principal weapon against insider trading. Specifically, Rule 10b-5 serves as the primary regulatory tool upon which criminal liability for securities fraud may be premised.

Recently in *United States v. O'Hagan*,\(^8\) the Supreme Court analyzed the SEC's regulatory anti-fraud provisions.\(^9\) The Su-
The Supreme Court held the "misappropriation theory" of liability as the proper means by which one may impose criminal liability under Rule 10b-5 of the '34 Act. This Note focuses upon the Supreme Court's employment of the misappropriation theory and the theory's interaction with the SEC's rules combating fraudulent investment practices. Part I of this Note reviews the development of the '34 Act, specifically, Rule 10b-5. Part II traces the Supreme Court's role in the evolution of the misappropriation theory. Part III discusses the potential pitfalls of the misappropriation theory, including its inapplicability to the language and intent of the regulatory tools, as well as its misapplication in United States v. O'Hagan. Part IV offers potential remedies to facilitate criminal liability under Rule 10b-5 without utilizing the misappropriation theory.

I. THE DEVELOPMENT OF SECURITIES REGULATION

The regulations implemented by the federal government to
combat the economic crisis of the early 20th century\(^1\) continue to play a pivotal role in the 1990's. After the stock market crash of 1929,\(^2\) the securities market was in dire need of reform\(^3\) in order to re-establish the free-market trading of securities. \(^4\) While the securities industry began to re-establish itself by raising substantial amounts of capital, the manner it which such capital was generated was questionable.\(^5\) The production of capital via inequitable investing practices by select members of the financial industry surfaced as a significant problem.\(^6\)

In order to curtail fraudulent activity, it was Congress' view...


\(^{14}\) See Joan K. Martin, *Insider Trading and the Misappropriation Theory: Has the Second Circuit Gone Too Far?*, 61 St. John's L. Rev. 78, 86 (1986) (examining applicability of misappropriation theory (citing S. REP. No. 73-47, 6-7 (1933))); see also S. REP. No. 73-792, 3 (1934) (discussing implementation of anti-fraud regulatory devices); S. REP. No. 73-1455, s1 (1934) (explaining stock market fears of increased buying potential of market traders).


\(^{17}\) See Keller & Gehlmann, *supra* note 13, at 330. In the decade after World War I, $50 billion of new securities were circulating in the United States - an estimated half of which were considered worthless because of the legislative belief of dishonest action by industry members. *Id.*

that anti-fraud provisions needed to be developed. In addition to several political and economic initiatives designed to invigorate a stagnant economy, Franklin D. Roosevelt planned to prevent fraudulent trading practices through government regulation of the securities industry. Upon his election, FDR acted promptly designating a commission to develop regulations for the financial community.

Along with the commission came the '34 Act which was designed to regulate the process by which securities are offered and sold to the public. In 1942, the SEC exercised its discretionary authority and promulgated Rule 10b-5. Specifically, Rule 10b-5 is equipped to work in conjunction with the boundaries of liability that Section 10(b) is designed to protect.

19 See SEC v. Materia, 745 F.2d 197, 201 (2d Cir. 1984) (noting extensive scope of antifraud provision encompassed all manipulative and deceptive practices which have been demonstrated to fulfill no useful function (quoting S. REP. NO. 73-792, at 6 (1934))); H.R. REP. NO. 75-85, at 2 (1933) (describing evolution and intent of governing anti-fraud regulations); see also Matthew K. Fong, Disclosure Guidelines For Land Based Securities, in CALIFORNIA DEBT ADVISORY COMMISSION AND STATE TREASURER ACTIONS 1997, at 835 (PLI Corp. L. Practice Course Handbook Series No. 7170, 1997); Harold Hangju Koh and Joan Choon Yoo, Dollar Diplomacy/Dollar Defense: The Fabric of Economic and National Security Law, 26 INT'L LAW. 715, 729-31 (1992) (showing how Congress hoped, by delegating authority to President, economic measures would be enacted to rescue economy).


22 See Bayne, supra note 18, at 489. Franklin D. Roosevelt named Felix Frankfurter, his informal advisor, and lifelong friend to develop the SEC Act. Id. Frankfurter, along with an elected three person panel, drafted the statute as we know it today. Id.

23 See id. at 489 n.123. The aforesaid panel utilized the British Companies Act of 1908 and 1929 as the theoretical model from which the SEC Act was derived. Id.; see also Ginger E. Margolin, Securities-Fraud-Private Plaintiffs May Not Maintain Aiding and Abetting Suits Under Securities Exchange Act Section 10(b) and Securities and Exchange Commission Rule 10b-5, 26 ST. MART'S L.J. 601, 605-07 (1995). The intent behind the enactment of the 1933-1934 Acts was to maintain the integrity of the stock market and thereby be worthy of public support. Id.


25 See 15 U.S.C. § 78j(b) (1998); see also In re Investors Management Co., 44 S.E.C. 633, 641 n.18 (1971) (broadening Rule 10b-5's authority to "information [o]btained by industrial espionage, commercial bribery or the like"); Oliver Sandlin, Arbor Day for "Judicial Oaks? The Supreme Court Implies a Right to Contribution in Section 10(b) Actions, 14 REV. LITIG. 289, 297-98 (1994) (stating Rule 10b-5 was promulgated by SEC in accordance with powers allotted).

focus of the drafters of Rule 10b-5 and Section 10(b), however, remains to restore the standard of excellence which pervaded the business community prior to the stock market crash of 1929.

II. THE EVOLUTION OF THE MISAPPROPRIATION THEORY

A. Imposition of Liability Via "Duty to Disclose"

Initially, the development of liability under Rule 10b-5 began when the standard of what constitutes a "duty to disclose" was developed. This duty served as one of the primary determinants of liability under the governing statute and regulation. For example, in Cady, Roberts & Co., a securities broker traded upon, without disclosing, material nonpublic information which he received from a director of his corporation. The SEC ruled that an insider must abstain from trading shares of his corpora-

private challenges under 10b-5 which are outside scope of 10(b)).


28 See Capital Gains Research Bureau, 375 U.S. at 186 (designating purpose of statute and regulation); Carlos J. Cuevas, The Misappropriation Theory and Rule 10b-5: Deadlock in the Supreme Court, 13 J. CORP. L. 793, 795 (1988) (stating legislative aims of Section 10(b) were: "(1) Designed to protect investors from fraudulent practices in the securities market; and (2) Encourage rapid dissemination of financial information which may have an impact on the value of a security").

29 See United States v. Chestman, 947 F.2d 551, 551 (2d Cir. 1992) (citing corporate insiders as primary target of regulatory tool); Phillip Issen v. GSC Enter., 508 F. Supp. 1298, 1302 (N.D. ILL. 1984) (re-affirming duty to disclose standard); see also Dirks v. SEC, 463 U.S. 646, 652 (1983) (noting affirmative duty to disclose on officers, directors or controlling stock holders when dealing in securities); Chiarella v. United States, 445 U.S. 222, 226 (1980) (stating affirmative duty to disclose has been traditionally imposed on corporate insiders); In re Cady, Roberts & Co., 40 S.E.C. 907, 910 (1961) (specifically, Commission ruled that duty arises when there is relationship affording access to inside information intended to be available only for corporate purpose); F. Arnold Daum & Howard W. Philips, The Implications of Cady, Roberts, 17 BUS. LAW. 939, 939 (1962) (examining evolution of duty to disclose).


tion unless he first discloses all of the material information known to him. Therefore, in order to prevent any deceptive trading practices on behalf of those on the "inside", an affirmative duty to disclose information evolved.

SEC v. Texas Gulf Sulfer Co., also played a significant role in the development of liability. The Second Circuit, in reversing the lower court's dismissal, convicted a geologist who possessed nonpublic information. The Second Circuit expanded exposure to liability, in order to rule within the confines of the statute. The court stated that in order to trade based upon material inside information the holder of such information must disclose it to the investing public. Texas Sulfer expanded the duty to disclose standard set forth in Cady by shifting the focus away from strictly insiders. Ultimately, Texas Sulfer served to im-
pose a duty on "anyone" who possesses and trades upon inside information. Recently, however, this duty was narrowed to encompass only "corporate insiders." Corporate insiders include officers, directors, and shareholders of corporations, as well as those possessing a fiduciary duty to the organization.

B. Classical Theory v. Advent of Misappropriation Theory of Liability

Courts have held that unless a party maintains "corporate insider" status there is no duty to disclose inside information imposed upon them. For example, in Chiarella v. United States, because the petitioner was not an agent of the corporation he worked for, he had no duty to disclose the inside information he possessed. The Supreme Court held that a duty to disclose arises from corporate insider relationships between parties and not from the mere possession of market information.

While the majority interpreted the statute as requiring "corporate insider" status in order to be subject to liability, the dissenting opinion by Chief Justice Burger served as the genesis of what the legal and financial communities have come to know as the misappropriation theory. Citing the history and lan-

its internal affairs. *Id.* Once this relationship is uncovered certain duties are imposed with respect to trading securities. *Id.*


See *id.* at 230. Corporate insiders deemed to be those officers, directors or shareholders of a corporation involved with and/or privy to the infrastructure of the organization. *Id.*

See *Chiarella*, 445 U.S. at 230.

See *id.* at 222. The petitioner had no affirmative duty to disclose what he had learned as a result of his relationship with the companies upon which he traded. *Id.* He was neither an agent, nor a trusted confidant, nor an employee, and thereby possessed no duty to disclose any information to them under Section 10(b) of the SEC Act of 1934. *Id.*

See *id.* at 230. The information upon which Chiarella relied and consequently traded upon, involved only the plans of the acquiring company. *Id.* Since the information was neither about the earning power, nor the operations of the organization, he did not owe an affirmative duty to disclose to anyone. *Id.*

See *id.* (defining corporate insiders to include officers, directors, controlling shareholders, and those who receive inside information from corporate insiders).

See *id.* at 240. Although the jury was never given the opportunity to hear it, the dissenting opinion of Chief Justice Burger was one of the most significant the Supreme Court has given. *Id.* From it, evolved the primary means by which criminal liability under Section 10(b) and Rule 10b-5 would be determined for years to follow. *Id.* Beginning
THE MISAPPROPRIATION THEORY

language of the '34 Act. Chief Justice Burger called for an approach that neither limits its application to strictly cases of corporate insiders, nor to "deceptive practices related to 'corporate information'. The misappropriation theory extends liability beyond traditional corporate insiders to any lawful possessor of material nonpublic information. The Chief Justice rationalized that the misappropriation theory will play a pivotal role in curtailing deceptive trade practices, while adequately supporting and facilitating the governing statute and rule.

Specifically, the misappropriation theory, as designed by Chief Justice Burger, would impose liability for an individual who:

1. Misappropriates nonpublic information
2. By breaching a duty that arises out of trust and confidence
3. Uses that information in a securities transaction
4. Regardless of whether he owed any duties to the shareholders of the traded stock.

The source of the nonpublic information does not in any way with the general rule that "neither party to an arm's length business transaction has an obligation to disclose information to the other. . . ." Burger rationalized that it allowed for the effort and hard work of any business person to achieve success. It permitted for everything from intensive research to in-depth market analysis. What it did not allow for, however, was the attainment of information through an illegal means. This would create an unfair market advantage, and would not be tolerated. Burger held that a duty to disclose should be raised upon illegally obtaining information, and consequently, when an individual misappropriates nonpublic information, they should have an "absolute duty" to disclose that information. Citing broad language, he holds that its provisions are designed to reach "any" individual engaged in such illegal practice, renouncing the belief that the statute was designed to reach only "corporate insiders." He supports this theory by distinguishing it through an analogy which states that by no means could Congress have intended such a distinction to be drawn between "anyone" and "insiders", the same way they could not have intended a "white collar" or "blue collar" insider distinction.

The next section of the infamous dissent addresses the history of the governing statute and rule. Burger cites the primary intent of the statute to be the termination of illegal, ill-intentioned securities trading on behalf of market members. Accordingly, an investor who conducts market transactions on the basis of information he has illegally misappropriated, clearly falls within the aforesaid statutory intentions. This, Chief Justice Burger held, is an intelligent and logical match which must carry our nation's economic arena into the future. He accuses the Court of not properly utilizing the misappropriation theory, as he herein has developed, and of not aptly charging the jury as to the implications of it. Specifically, Burger held that the lack of jury instructions "possibly influenced the jury adversely to [the defendant]".

See id. at 241 (explaining how Burger reasoned misappropriation theory's application to be in harmony with Rule 10b-5).

See id. (implementing broad statutory application).

See id. (documenting applicability of misappropriation theory).

See id. (elaborating on future of misappropriation theory in securities fraud cases).

have to be directly related to the securities transaction. Additionally, the fraud requirement of Rule 10b-5 is fulfilled upon the act of misappropriating the information from a person who has a fiduciary relationship with a corporation. The aforesaid fraud is deemed to satisfy the “in connection with” language of the '34 Act when the information is utilized in a securities transaction.

The Supreme Court refused to adopt the misappropriation theory in Chiarella, and continued to apply the “classical theory” as the means by which to impose liability under the act. The classical theory requires the breach of a fiduciary duty by an individual who buys or sells securities. The offender must also be trading securities of a corporation of which he/she is an insider. The classical theory is in accordance with the statutory language of Section 10(b) and Rule 10b-5 in that it requires the fraud to be “in connection with the purchase or sale of any secu-

54 See Weiss & Walder, supra note 53, at 37 (documenting evolution of fraud requirement of misappropriation theory).
55 See id. at 37 (applying elements of misappropriation theory).
56 See Chiarella, 445 U.S. at 222. The Supreme Court held that:
(1) employee could not be convicted on theory of failure to disclose his knowledge to stockholders or target companies as he was under no duty to speak, in that he had no prior dealings with the stockholders and was not their agent or fiduciary and was not a person in whom sellers had placed their trust and confidence, but dealt with them only through impersonal market transactions; (2) Section 10(b) duty to disclose does not arise from the mere possession of nonpublic market information; and (3) court would not decide whether employee breached a duty to acquiring corporation since such theory was not submitted to the jury.

57 See Chiarella, 445 U.S. at 227-30. The court held the elements of the classical theory, constituted a Rule 10b-5 violation when buyers/sellers of securities:
(i) owe a fiduciary duty to the other party to the transaction; (ii) owe a fiduciary duty to the shareholders of the company in whose shares they are trading by virtue of their position as an insider of the corporation; or (iii) are tippees who received information from such an insider and know or should know that the insider breached a fiduciary duty in giving the information.

59 See Lindquist, supra note 27, at 201 (explaining corporate insider status).
rather than the breach of a fiduciary duty, which may or may not be connected with a securities transaction.

In *Dirks v. SEC*, the Supreme Court, while focused on the corporate insider, expanded liability under Section 10(b) to apply not simply to traditional insiders, but also to those possessing merely temporary insider status. The appellant was deemed a temporary insider by virtue of receiving information from a former client and employee of a firm who stated that the firm's assets were grossly overstated. While Dirks never actually traded on or profited from such information, the fact that he informed clients of the news caused the firm's stock to decline. The Supreme Court upheld the court of appeals' decision convicting Dirks on the grounds that he had a duty to disclose such information as he received it from a corporate insider.

---

60 See 17 U.S.C. § 78j(b) (1998) (exhibiting text of section 10(b) and Rule 10b-5).
61 See id. (describing elements of statutory violation).
63 See id. at 655 (explaining how tippee breaches fiduciary duty assumed from insider, when transmitting information to someone who will trade on basis thereof).
64 See id. at 646. Petitioner received information that documented corporate malpractice which severely overestimated corporate assets. Id. at 648-50. Although he openly discussed his findings, senior management of the aforesaid corporations denied any wrongdoing whatsoever. Id. Petitioner was confronted by a former officer of the corporation in question. Id. The officer disclosed to him, and at the same time urged Dirks to disclose to the public, the fact that the corporations assets were overstated, and that various regulatory agencies had conveniently failed to act on such charges. Id. Additionally, while conducting his investigation, Dirks kept a New York based Wall Street Journalist abreast of his findings. Id. The journalist was hesitant, however, to publish any report of the alleged wrongdoing, as the magnitude of such was uncanny. Id. He eventually did publish the story upon the sudden stock price plunge and consequential SEC investigation. Id. at 649.
65 See id. at 646. Dirks was employed at a firm which specialized in investment analysis of insurance company securities to institutional investors. Id.
66 See id. 650. Despite never actually trading upon the information acquired, Dirks was said to have "aided and abetted" various statutory violations, specifically section 10(b) and Rule 10b-5. Id. He was considered to have committed fraud upon other members of the investment community who received and traded upon the information he offered to them. Id. at 650-51.
67 See id. at 649-50 (providing statistical information regarding decrease in stock price).
68 See id. at 659. The Supreme Court expanded the traditional notion of corporate insider gleaned from *Chiarella* to include tippee's, temporary insiders, and buyers/sellers of securities. Id. Specifically, the Supreme Court enumerates a duty in tippee's akin to that of corporate insiders. Id. Holding that they receive the information which they trade upon illegally, as do most insiders, a duty evolves to disclose it, not because of the nature of the information, but because of the manner in which they received it. Id. at 660. Additionally, the court analyzed whether there is a breach of duty by carefully scrutinizing the nature of the tip received. Id. Relevant inquiries involve the personal benefit received by the insider as a result of the disclosure. Id. at 660-61. To determine whether a tippee is under an obligation to disclose or abstain [from using nonpublic material information from an insider], it is necessary to determine whether the insiders tip constituted a
delegation of a "temporary" insider status makes the classical theory a more adaptive and effective tool with which liability under Section 10(b) can be imposed. While expanding from a traditional to temporary insider, the classical theory still imposes liability on parties directly involved in the securities transaction.

III. WHY THE MISAPPROPRIATION THEORY IS NOT VALID

The misappropriation theory is becoming one of the primary means by which liability is imposed under Rule 10b-5. Until United States v. O'Hagan, the Supreme Court was not faced with the opportunity to determine the validity of the misappropriation theory as a means of liability.

In O'Hagan, the defendant was a partner in a law firm which represented a corporation, Grand Metropolitan, regarding a potential tender offer of Pillsbury. While O'Hagan did not possess a direct relationship with Pillsbury, he did trade its stock. O'Hagan was consequently convicted of being privy to, trading upon, and profiting from inside information gleaned from a relationship his firm shared with a client. The Supreme Court

breach of the insider's fiduciary duty. Id. The test is whether the insider will benefit from his disclosure. Id. Absent personal gain, there is no breach of duty to stockholders, and without a breach by the insiders, there is no derivative breach. Id. at 682.

69 See William A. Snider, Securities Law - All in the Family - U.S. v. Chestman: Finding a Fiduciary or Other Similar Relation of Trust and Confidence under Rule 10b-5 For Family Members of a Family Controlled Publicly Traded Corporation, 16 W. New Eng. L. Rev. 79, 83-84 (1994) (describing history of classical theory of insider trading liability in two Supreme Court cases); see also Dworkin, supra note 9, at 322 (stating that Dirks court extended liability to temporary insiders); Corey Smith, Extraterritorial Enforcement of Rule 10b-5: Insider Trading in International Equities Market, 12 Suffolk Transnat'L L. Rev. 83, 91 (1988) (defining "temporary insiders").


73 See id. at 2199 (evaluating appropriateness of misappropriation theory).

74 See id. at 2199 (reasoning how O'Hagan did not possess significant relationship with client).

75 See id. (articulating innocent trading behavior of O'Hagan).

76 See id. (explaining relationship of O'Hagan, his firm, and firm's client).
held the misappropriation theory as a valid means by which criminal liability may be predicated under Rule 10b-5.\footnote{See id. (finding criminal liability under misappropriation theory); see also Richard Phillips, The Supreme Court's Decision in O'Hagan: A Choice of Judicial Pragmatism over Ideology, in SECURITIES ENFORCEMENT INSTITUTE: A PRACTICAL GUIDE TO INVESTIGATION, SETTLEMENT & LITIGATION 1997, at 237, 248 (PLI Corp. L. & Practice Course Handbook Series No. B4-7240, 1997) (describing Eighth Circuit's decision in O'Hagan); Bruce Hiter, United States v. O'Hagan, 11 NO. 9 INSIGHTS 2, 3 (1997) (explaining Supreme Court's analysis in O'Hagan).}

The Court's use of the misappropriation theory as a means by which criminal liability is established for securities fraud, must be re-examined if it is to comport with Rule 10b-5.\footnote{See O'Hagan, 117 S. Ct. at 2207. "The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporations security price when revealed..." Id.}

In \textit{O'Hagan}, the Chief Justice, and Justices Scalia and Thomas dissented from the majority's imposition of criminal liability under Rule 10b-5.\footnote{See O'Hagan, 117 S. Ct. at 2220 (reasoning that section 10(b) and Rule 10b-5 do "...not seem to accord with the principle of lenity we apply to criminal statutes"); see also Reno v. Koray, 515 U.S. 50, 64-65 (1995) (documenting aforesaid principles of criminal lenity); United States v. Chestman, 947 F.2d 551, 570 (2d Cir. 1991) (stating that more than "perfunctory need" of rule of lenity is required for a Rule 10b-5 criminal conviction). See generally Liparota v. United States, 471 U.S. 419, 427 (1985) (stating that application of rule of lenity strikes appropriate balance between legislature, prosecutor and court); United States v. Bass, 404 U.S. 336, 347-48 (1971) (expounding on policies of criminal lenity).}

Their primary argument focuses on the misappropriation theory's inability to comport with the "in connection with" language of the statute.\footnote{See generally SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990). The court states that fraudulent "practices merely have to be 'in connection with' security purchases or sales." Id.; United States v. Elliot, 711 F.Supp 425, 431 (N.D. Ill. 1989). "[T]he statute's language broadly prohibits 'in connection with the purchase or sale of any security'." Id.}

The dissenting Justices

\footnote{See O'Hagan, 117 S. Ct. at 2220-21; see also Timothy J. Horman, In Defense of U.S. v. Bryan: Why the Misappropriation Theory is Indefensible, 64 FORDHAM L. REV. 2455, 2506 (1996). "The misappropriation theory fails to meet the 'in connection with' requirement of Section 10(b)." Id.; Jay G. Merwin, Jr., Misappropriation Theory Liability Awaits a Clear Signal, 51 BUS. LAW. 803, 805 (1996). After fifteen years of finding civil and criminal liability under the misappropriation theory, the courts have still yet to define the range of relationship whose breach can generate a duty to disclose. Id. But see William R. Lucas & Alma M. Angotti, Insider Trading: Is it Back or Did it Ever Really Go Away?, 9 NO. 10 INSIGHTS 2, 8 (1995). The rejection of the misappropriation theory would create a gaping hole in the rules and may leave open the possibility that people could easily commit fraud in connection with their securities transactions. Id.}
urge a reversion to the classical theory of predicating criminal liability under Rule 10b-5.82 The classical theory is a more appropriate means of liability, focusing on those who possess a direct relationship between the alleged fraud and the securities transaction.84 The ‘34 Act, therefore, must be strictly construed in order to keep with the overall legislative goal of curtailing illegal trading activity of corporate insiders in the securities market.85

The language of the ‘34 Act unambiguously requires that the imposition of criminal liability be limited to corporate insiders who misappropriate material, nonpublic information in connection with a securities transaction.86 The misappropriation theory, however, imposes criminal liability for the breach of a fiduciary duty, irrespective of whether the breach was in connection with a securities transaction.87 The intent of the legislature in drafting the ‘34 Act focuses on apprehending corporate insiders engaged in deceptive trading practices.88 The misappropriation theory, however, imposes criminal liability for the breach of a fiduciary duty, irrespective of whether the breach was in connection with a securities transaction.87 The intent of the legislature in drafting the ‘34 Act focuses on apprehending corporate insiders engaged in deceptive trading practices.88 The misappropriation

82 See O'Hagan, 117 S. Ct. at 2219 (explaining why classical theory is preferred means to impose criminal liability).
84 See Douglas Hunt & Michael R. Seyle, Carpenter v. United States: Securities Trading, Mail Fraud and Confidential Business Information - New Liability for Outsiders?, 20 PAC. L.J. 839, 845 (1989). "[T]he misappropriation theory represents a significant departure from early 10b-5 liability analysis because it focuses upon the employee's fiduciary duty to an employer instead of upon the duty owed to the shareholder's of the corporation." Id. See generally Misappropriation Theory of Insider Trading, 111 HARV. L. REV. 410, 412 (1997). This article analyzes the potential weaknesses of the misappropriation theory and why it should no longer be applied. Id.; David Bayne, Insider Trading: The Demise of the Misappropriation Theory and Thereafter, 41 ST. LOUIS U. L.J. 625, 642 (1997). The author advocates numerous reasons why the classical, not the misappropriation theory is more in accord with the statutory goals and language. Id.
85 See O'Hagan, 117 S. Ct. at 2199 (dissenting opinion by Scalia calling for leniency of interpretation of criminal statutes).
87 See Chiarella, 445 U.S. at 222 (documenting why misappropriation theory is not applicable).
88 See H.R. CONF. REP. NO. 73-152, at 152 (1933) (discussing particular transactions statute is designed to combat); Scott J. Davis & Joseph A. Starkman, Liability Under
theory seemingly imposes criminal liability upon individuals outside the scope of corporate insiders. While it is important that all deceptive trade practices are properly governed, the '34 Act is designed only to apprehend the illegal activity of corporate insiders.89

A. The Classical Theory of Liability - A Theory Better Suited to Impose Liability Under the '34 Act and Rule 10b-5

A more conventional and appropriate measure upon which criminal liability for securities fraud may be predicated is the classical theory.90 In applying the classical theory, the courts focus primarily upon the "in connection with" language of the statute.91 The classical theory requires a nexus between the breach of a fiduciary duty by an insider and the shareholder with whom the insider transacts, thereby limiting the imposition of criminal liability to only corporate insiders.92 The misappropriation the-
ory, conversely, imposes criminal liability upon everyone related to the securities transaction, irrespective of the degree to which a party may be removed from the inside information. Therefore, the classical theory is a more effective means to impose Rule 10b-5 criminal liability, and to protect the financial industry from deceptive corporate insider trading practices.

B. The Misappropriation Theory Does Not Comport with the Language of the '34 Act

By imposing criminal liability upon an individual who breaches simply any fiduciary duty, the misappropriation theory completely disregards the language in the '34 Act. The '34 Act requires alleged fraudulent activity to be "in connection with" or "related to" securities transactions. In order to bring a 10b-5 suit, the statute demands that the source of the information be either a purchaser or seller of securities or affiliated with the purchase or sale of securities. Only these aforementioned parties may be subject to liability under the classical theory. Under the misappropriation theory, however, the focus is on "fraud on the source" with respect to the imposition of liability. In


See Kenny & Thebault, supra note 90, at 141 (analyzing potential dangers of applying misappropriation theory to all investors).

See id. at 141 (stating because of vague standards in misappropriation theory, normal market behavior may be swept up in financial unfairness dragnet); see also United States v. Bryan, 58 F.3d 933, 935 (4th Cir. 1995) (discussing misappropriation theory as too vague to be encompassed in Section 10(b)); cf. Christine Marra, The Misappropriation Theory: A Practical Means of Imposing Rule 10b-5 Liability, 24 U. RICH. L. REV. 211, 214 (1990) (explaining misappropriation theory to be superior means of implementing policy goals of Rule 10b-5).

See Santa Fe Indus., Inc., v. Green, 430 U.S. 462, 476-77 (1977) (describing the act, its "[b]road congressional purpose [to] protect investors from false and misleading practices that might injure them"); see also Harvey L. Pitt et. al., Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct, in ADVANCED SECURITIES LAW WORKSHOP 1997, at 301, 306 (PLI Corp. L. & Practice Course Handbook Series No. B4-7209, 1997) (enumerating preventive measures to be taken to combat fraudulent trading practices); Bayne, supra note 18, at 520 (stating "[t]he wording of 10(b), making fraud in connection with the purchase or sale of a security a violation of the Act, is surely badly stretched when construed to provide a cause of action, not to purchasers and sellers of securities, but the world at large").

See Santa Fe, 430 U.S. at 476 (enumerating who has standing).

other words, a plaintiff need only establish fraud, irrespective of its connection with the securities transaction, in order to bring a Rule 10b-5 claim.98

The misappropriation theory exceeds the corporate insider scope of the regulatory statutes by imposing criminal liability upon everyone associated with the transaction.99 Consequently, although criminal liability may correctly be imposed upon a corporate insider, it may also be incorrectly applied to apprehend an individual whom Rule 10b-5 is not designed to govern.100 Problems arise from the lack of clarity with respect to the definition of the source of the nonpublic information, therefore, allowing unintended parties to be found liable.

The aforementioned problem is evident in the ‘34 Act which is narrowly worded to impose criminal liability upon a limited group of security traders, the corporate insider.101 While other regulations may address those who are not corporate insiders the ‘34 Act remains narrow in its scope, exemplified by the stat-


99 See Chiarella v. United States, 445 U.S. 222, at 234-35 (1980) (explaining inapplicability of misappropriation theory to securities fraud cases); Natowitz v. Mehman, 567 F. Supp. 942, 945 (S.D.N.Y 1983) (refusing to consider SEC transaction integral or helpful to fraudulent scheme so as to be under statute). See generally In re Financial Corp. of Am. v. Arthur Anderson & Co., 796 F.2d 1126, 1129 (9th Cir. 1986) (explaining that interpretation of Supreme Court takes on paramount importance because of statutes broad language); Kenny & Thebault, supra note 50, at 141 (citing higher degree of concentration on corporate insiders).

100 See Sante Fe., 430 U.S. at 463 (noting provision is concerned with fairness of conduct toward persons such as family members, employers, or parties to infinite number of similar trust relationships who are not in any way connected with or even interested in purchase or sale of securities); see also Bayne, supra note 84, at 636 (discussing misappropriation theory and buyers/sellers role in it); Phillips & Avon, supra note 91, at 250 (enumerating Courts rejection of position of Eighth Circuit holding Rule 10b-5 only to cover deception of purchasers and sellers of securities).

ute's legislative history. If the legislature wished to condemn those individuals who possess inside information, but who are not privy to the securities transaction, it appears that additional legislation would have been adopted.

Proponents of the misappropriation theory argue that it does in fact encompass the requisite deception language that the statute requires. Arguably, the misappropriation theory may be a valid basis upon which liability may be predicated if deception, breach of a fiduciary duty, and a securities transaction are all present. There is a problem, however, when no correlation exists between the breach of a fiduciary duty, the deception, and the securities transaction. Deception alone, for example, does not satisfy the statute's requirements. Proponents of the misappropriation theory argue that even if deception is remotely connected with a securities transaction, it may in and of itself, satisfy the "in connection with" statutory language. This could result in liability being imposed upon individuals who are neither directly involved with the transaction, nor have breached a fiduciary duty. O'Hagan exemplifies this problem by imposing liability upon a person who had no fiduciary duty and who

102 See Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 173 (1994). There is a "[v]iolation only when there is intentional or willful conduct designed to deceive or defraud investors." Id.; see also Martha L. Cochran, Litigating and BeSpeaking Caution Under the New Securities Law, in SWEEPING REFORM 1996, at 31, 34 (PLI Corp. L. & Practice Course Handbook Series No. B4-7152, 1996). Rule 10b-5 is used for private actions, however, it is under debate whether it is available for recklessness. Id.

103 See Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 10 (1971). The court looks to misappropriation theory as fulfilling deception requirement of statute, but at the same time, disregards "in connection with" statutory language. Id.; see also Humke, supra note 58, at 841. "Indeed, the necessity for misappropriation liability may be exaggerated. Chiarella and Dirks established an ambit of prohibited conduct within which the vast majority of Section 10(b) offenses hitherto prosecuted have fallen." Id.; Michael J. Voves, United States v. O'Hagan: Improperly Incorporating Common Law and Fiduciary Obligations into Section 14(e) of the Securities Exchange Act, 81 MINN. L. REV. 1015, 1017 (1997). The primary focus is to exhibit lack of fiduciary relationships possessed by most insiders. Id.

104 See United States v. O'Hagan, 117 S. Ct. 2199, 2220 (1997). Justice Thomas' dissent calls for the touchstone requirement of statutory language to be "necessarily and only consummated by the transaction, not that it merely coincide with the transaction" Id.

105 See id. at 2220 (promoting theory that more aptly focuses on corporate insider).

106 See Head v. Head, 759 F.2d 1172, 1175 (4th Cir. 1985) (citation omitted) (noting 'de minimis touch test' might make any securities transaction actionable under Rule 10b-5). But see Britt v. Cyril Bath Company, 417 F.2d. 433, 440 (6th Cir. 1969) (noting that even though language is broad, casual connection must still be made for common "in connection with" language).

THE MISAPPROPRIATION THEORY

1998]

108 See O'Hagan, 117 S. Ct. at 2199 (stating innocence of O'Hagan's securities transactions); United States v. Charney, 537 F.2d 341, 357 (9th Cir. 1976) (arguing that market manipulation should be keyed upon for purposes of stock market fraud).


110 See SEC v. Clark, 915 F.2d 439, 441 (9th Cir. 1990). According to the legislative history supporting two modern-day regulatory acts, the applicability of Section 10(b) and Rule 10b-5 are affirmed. Id. Specifically, with the Insider Trading Sanctions Act ("ITSA") of 1984, Congress re-affirmed the power vested in the SEC to impose penalties on those who trade on material, nonpublic information. Id. Congress also considered expressly defining "insider Trading", but opted not to, as it presented too great a challenge. Id.; see also Karl Groskaufmanis, The SEC's Enforcement Nose Dive, LEGAL TIMES, Dec. 16, 1991, at 21-22 (articulating concerns of Congress regarding expressly defining "insider trading").


112 See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 723 (1975) (holding respondent was not entitled to sue for violation of Rule 10b-5); SEC v. Clark, 915 F.2d 439, 448 (9th Cir. 1990) (stating how any person or either side of transaction could violate fiduciary duty); SEC v. Singer, 786 F. Supp. 1158, 1163 (S.D.N.Y. 1992) (describing fiduciary relationship as one of trust and confidence).
transaction.\textsuperscript{113} The misappropriation theory incorrectly allows for criminal liability to evolve from a breach of a fiduciary duty by a corporate "outsider", not to the trading party, but to the source of the information.\textsuperscript{114} This breach of a fiduciary obligation, absent the requisite fraudulent intent and deceit, may not constitute a violation under Section 10(b) and Rule 10b-5.\textsuperscript{115}

In order to comply with the requirement of manipulative and fraudulent securities trading, courts have recognized the "silent transaction".\textsuperscript{116} In other words, mere inaction by a person in possession of inside information may qualify as a transaction in order to impose liability. Such silence, however, must be coupled with the requisite duty to disclose.\textsuperscript{117} This duty to disclose was not present in \textit{O'Hagan}, yet liability was inexplicably found under the misappropriation theory with only the "silent transaction" as a basis for the conviction.

2. "In Connection With"

The intent of the federal standards set forth is to focus on the breach of a fiduciary relationship connected with a securities transaction.\textsuperscript{118} The misappropriation theory, however, attempts

\textsuperscript{113} See Santa Fe Indus., Inc. v. Greene, 430 U.S. 462, 465 (1977) (holding transaction that was neither deceptive nor manipulative did not violate either Section 10(b) or Rule 10b-5); SEC v. Maio, 51 F.3d 623, 626 (7th Cir. 1995) (noting that one does not have to be "insider" to breach fiduciary duty); SEC v. Musella, 578 F. Supp. 425, 426 (S.D.N.Y. 1989) (outlining why liability rests solely upon whether fiduciary relationship has been created).

\textsuperscript{114} See \textit{Blue Chip}, 421 U.S. at 733 n.5.

The wording of 10(b), making fraud in connection with the purchase or sale of a security a violation of the act, is surely badly strained when construed to provide a cause of action, not to purchasers and sellers of securities, but to the world at large." Id.; see also Shawnut Bank v. Kress Assoc., 33 F.3d 1396, 1452 (3rd Cir. 1994) (noting that fiduciary question essential to this case must be met before proceeding); Frain v. Frain, Inc., 660 F.Supp. 97, 103 (N.D. Ill. 1987) (enumerating plaintiff as having burden of proving fiduciary relationship exists under 10(b) claim).

\textsuperscript{115} See \textit{Blue Chip}, 421 U.S. at 733 (claiming how misappropriation theory may not impose criminal liability on entire financial world).

\textsuperscript{116} See Chiarella v. United States, 445 U.S. 222, 229 (1980). The problem with this argument is that liability based upon silence is premised on a duty to disclose which arises from a fiduciary relationship between parties. Id.

\textsuperscript{117} See \textit{id.} at 226 (ruling that silence in and of itself may not constitute violation under 10b-5).


\[e\]ven if \textit{O'Hagan} or someone else thereafter used the information to trade, the misappropriation would have been complete before the trade and there should be no Section 10(b) liability. The most obvious real-world example of this scenario would be if \textit{O'Hagan} had simply tipped someone else to the information. The mere act of passing the information along would have violated \textit{O'Hagan}'s fiduciary duty... regardless of whether the tippee later traded on the information.
to impose liability without addressing the "in connection with" language of the governing statute and regulation. As a result, courts may impose liability, using the misappropriation theory, upon people having no connection or duty to the institution for whom the information pertains, but who inadvertently pick upon inside information. The misappropriation theory, therefore, is inconsistent with the legislative intent of Section 10(b) and Rule 10b-5 because it fails to focus on an insiders duty to the issuing shareholders of a company in connection with a securities transaction.

IV. PROPOSED REMEDIES

The courts should digress from the misappropriation theory, and utilize the classical theory for future review of fraudulent practices. The classical theory is more in accord with the goals of the '34 Act, however, so long as it remains available only on a theoretical basis it will be continually scrutinized by its


120 See SEC v. Cherif, 933 F.2d 403, 403 (7th Cir. 1991). The court ruled that a person violates Rule 10b-5 and Section 10(b) by misappropriating and trading upon material information entrusted to him by virtue of a fiduciary relationship such as employment. Id.; SEC v. Willis, 797 F. Supp. 165, 165 (S.D.N.Y. 1991). The district court stated cause of action existed against broker for securities fraud based on misappropriation theory. Id.; United States v. Winanc, 612 F. Supp. 827, 827 (S.D.N.Y. 1985). The court said the misappropriation theory of liability for securities and mail fraud was an applicable basis for convictions of a reporter and investor engaged in a fraudulent scheme. Id.

121 See Chiarella, 445 U.S. at 222. The misappropriation theory imposes liability for an individual who:

1. Misappropriates nonpublic information (2) by breaching a duty that arises out 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.

122 See O'Hagan, 117 S.Ct. at 2202. "Under the 'classical theory' there is a relationship of trust and confidence between the corporation's shareholders and the insider that gives rise to a duty to disclose or abstain from trading." Id.
users. The courts should utilize strict scrutiny when interpreting the words of the '34 Act. Such careful consideration of the Act's meaning will ensure the apprehension of corporate insiders who improperly misappropriate nonpublic information.

While the misappropriation and classical theories present different standards, they both attempt to prevent fraudulent securities trading. Legislation should be developed which encompasses corporate insiders and all others that engage in deceptive trading practices. Such legislation may, in fact, serve to protect investors from illegal trading practices by both the corporate insider and those who possess no insider relationship to the traded securities at all.

Theories work on a debatable level, but are left open to scrutiny which may facilitate their premature demise. Therefore, the application of the classical theory to facilitate the '34 Act, may potentially create ambiguities, absent specific regulatory language that recognizes the role that the classical theory will play. In other words, in order to be truly effective, the legislature must directly articulate the behavior that the classical theory is specifically designed to combat. Once specific language is drafted on how, when, and why the classical theory will aid the '34 Act in combating deceptive trading practices, a strict scrutiny analysis should be employed by regulatory commissions and judges. Such careful consideration of the application of the classical theory would effectively and efficiently achieve justice, punishing those offenders the statute's drafters originally intended to target.

**CONCLUSION**

The recent Supreme Court decision supporting the misappropriation theory is in contrast with the goals, standards, and intent of the governing federal statute and regulation. Reversing the applicability of the misappropriation theory is essential to carrying out the intent of the '34 Act, to punish corporate insid-

---

123 See id. at 2199 (explaining how primary focus of Supreme Court is to apprehend violators of securities fraud).

124 See 17 C.F.R. § 240.10b-5 (1998). The SEC has the rule-making authority to provide the means it deems necessary to achieve the ends of Section 10(b). Id. It promulgated Rule 10b-5 in this manner. Id. Why not codify the classical theory so as to eliminate any doubt as to which theory is to be used? Id. See generally Huddleston v. Maclean, 640 F.2d 534, 543 (5th Cir. 1981). There is a need for clarification of Section 10(b). Id.
ers for fraudulent securities trading.

Mark A. Dessi