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THE ICONIC INSIDER TRADING CASES

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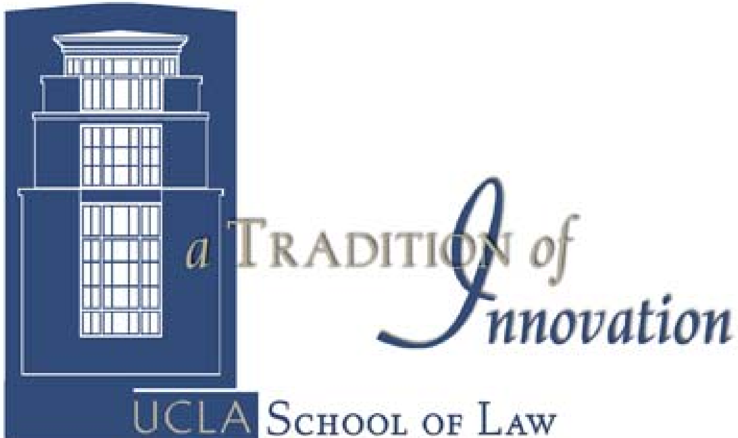

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The Iconic Insider Trading Cases

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***Abstract*:** This essay traces the evolution of insider trading jurisprudence, focusing on the three iconic Supreme Court decisions: *Chiarella, Dirks, and O'Hagan*. The essay argues that all three cases were seriously flawed because each failed to cohere as to either policy or doctrine. Just as a child might break his toy by attempting to force a square peg into a round hole, the Supreme Court made a hash of insider trading law (and Rule 10b-5 generally) by attempting to force insider trading into a paradigm—securities fraud—that does not fit.

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I. Introduction

The modern federal insider trading prohibition fairly can be said to have begun with the Securities and Exchange Commission's (SEC or "Commission") enforcement action in *Cady, Roberts & Co.*[1] Curtiss-Wright Corporation's board of directors decided to reduce the company's quarterly dividend. One of the directors, J. Cheever Cowdin, was also a partner of stock brokerage firm Cady, Roberts & Co. Before the news was announced, Cowdin informed one of his partners, Robert M. Gintel, of the impending dividend cut. Gintel then sold several thousand shares of Curtiss-Wright stock held in customer accounts over which he had discretionary trading authority. When the dividend cut was announced, Curtiss-Wright's stock price fell several dollars per share. Gintel's customers thus avoided substantial losses.

Cady, Roberts involved what is now known as tipping: an insider who knows confidential information does not himself trade, but rather informs—tips—someone else, who does trade. It also involved trading on an impersonal stock exchange, instead of a face-to-face transaction. As the SEC acknowledged, this

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[1] In re Cady, Roberts & Co., 40 S.E.C. 907, 1961 WL 3743 (1961).

made it "a case of first impression."[2] Nonetheless, the SEC held that Gintel had violated Rule 10b-5.

II. The Insider Trading Prohibition Emerges

It was not immediately clear whether *Cady, Roberts* would have significant precedential value.[3] It was an administrative ruling by the SEC, not a judicial opinion. It involved a regulated industry closely supervised by the SEC. Neither the text of the statute nor its legislative history mandated a broad insider trading prohibition.[4]

In *SEC v. Texas Gulf Sulphur Co.*,[5] however, the Second Circuit set a major precedent accepting the SEC's argument that insider trading violated Rule 10b-5. In March 1959, agents of Texas Gulf Sulphur Co. (Texas Gulf Sulphur)—a mining corporation—began aerial surveys of an area near Timmins, Ontario. Evidence of an ore deposit was found. In October 1963, Texas Gulf Sulphur began ground surveys of the area. In early November, a drilling rig took core samples from depths of several hundred feet. Visual examination of the samples suggested commercially significant deposits of copper and zinc. Texas Gulf Sulphur's president ordered the exploration group to maintain strict confidentiality, even to the point of withholding the news from other Texas Gulf Sulphur directors and employees. In early December, a chemical assay confirmed the presence of copper, zinc, and silver. At the subsequent trial, several expert witnesses testified that they had never heard of any other initial exploratory drill hole showing comparable results. Over the next several months, Texas Gulf Sulphur acquired the rights to the land under which this remarkable ore deposit lay. In March and early April 1964, further drilling confirmed that Texas Gulf Sulphur had made a significant ore discovery. After denying several rumors about the find, Texas Gulf Sulphur finally announced its discovery in a press conference on April 16, 1964.

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[2] *Id.* at *1.

[3] See, e.g., Recent Decision, 48 VA. L. REV. 398, 403-04 (1962) ("in view of the limited resources of the Commission, the unfortunate existence of more positive and reprehensible forms of fraud, and the inherent problems concerning proof and evidence adhering to any controversy involving a breach of duty of disclosure, there is little prospect of excessive litigation evolving pursuant to [*Cady, Roberts*]").

[4] *See* Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1228-34 (1995).

[5] 401 F.2d 833 (2d Cir.), *cert. denied*, 394 U.S. 976 (1968).

Throughout the fall of 1963 and spring of 1964, a number of Texas Gulf Sulphur insiders bought stock and/or options on company stock. Others tipped off outsiders. Still others accepted stock options from the company's board of directors without informing the directors of the discovery. Between November 1963 and March 1964, the insiders were able to buy at prices that were slowly rising, albeit with fluctuations, from just under $18 per share to $25 per share. As rumors began circulating in late March and early April, the price jumped to about $30 per share. On April 16th, the stock opened at $31, but quickly jumped to $37 per share. By May 15, 1964, Texas Gulf Sulphur's stock was trading at over $58 per share—a 222% rise over the previous November's price. Any joy the insiders may have taken from their profits was short-lived, however, as the SEC sued them for violating Rule 10b-5.

In *Texas Gulf Sulphur*, the Second Circuit held that when an insider has material nonpublic information Rule 10b-5 requires that the insider must either disclose such information before trading or abstain from trading until the information has been disclosed. Thus was born what is now known as the "disclose or abstain" rule: An insider in possession of material nonpublic information must disclose such information before trading or, if disclosure is impossible or improper, abstain from trading.

The policy foundation on which the Second Circuit erected the disclose or abstain rule was equality of access to information. The federal insider trading prohibition purportedly was necessary to ensure that "all investors trading on impersonal exchanges have relatively equal access to material information."[6] Put another way, Congress purportedly intended "that all members of the investing public should be subject to identical market risks."[7]

To consider the potentially expansive scope of the equality of access principle, suppose a Texas Gulf Sulphur representative had approached a landowner in the Timmins area to negotiate purchasing mineral rights to the land. Texas Gulf Sulphur's agent does not disclose the ore strike, but the landowner knows Texas Gulf Sulphur has been drilling in the area and has heard rumors that it has been buying up a lot of mineral rights. She puts two and two together, reaches the obvious conclusion, and buys some Texas Gulf Sulphur stock. Under a literal reading of *Texas Gulf Sulphur*, is our landowner liable for illegal insider trading?

Probably. The *Texas Gulf Sulphur* court stated that the insider trading prohibition applies to "anyone in possession of material inside information,"

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[6] *Id.* at 847.

[7] *Id.* at 852.

because §10(b) was intended to assure that "all investors trading on impersonal exchanges have relatively equal access to material information."[8] The court further stated that the prohibition applies to anyone who has "access, directly or *indirectly,*" to confidential information if she knows that the information is unavailable to the investing public.[9] The only issue thus perhaps would be a factual one turning on the landowner's state of mind: did she know she was dealing with confidential information. If so, the equal access policy would seem to justify imposing a duty on her.

III. The Supreme Court Sets Limits

In *Chiarella v. United States,*[10] the Supreme Court concluded that equal access test went too far. Vincent Chiarella was an employee of Pandick Press, a financial printer. In preparing tender offer disclosure materials, Pandick used codes to conceal the names of the companies involved, but Chiarella broke the codes. He purchased target company shares before the bid was announced, then sold the shares for considerable profits after announcement of the bid.

Chiarella was caught and convicted of violating Rule 10b-5 by trading on the basis of material nonpublic information. The Second Circuit affirmed his conviction, applying the *Texas Gulf Sulphur* equality of access to information-based disclose or abstain rule. Under that standard, Chiarella loses because he had superior access to information than those with whom he traded.

The Supreme Court reversed. In doing so, the court rejected the notion that §10(b) was intended to assure all investors equal access to information. The court could not affirm Chiarella's conviction without recognizing a general duty between all participants in market transactions to forego trades based on material, nonpublic information, which it declined to do.[11]

Chiarella thus made clear that the disclose or abstain rule is not triggered merely because the trader possesses material nonpublic information. When a 10b-5 action is based upon nondisclosure, there can be no fraud absent a duty to speak, and no such duty arises from the mere possession of nonpublic information.[12] Instead, the disclose or abstain theory of liability for insider trading was now premised on the inside trader being subject to a duty to disclose to the party on the

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[8] *Id.* at 847.

[9] *Id.*

[10] 445 U.S. 222 (1980).

[11] *Id.* at 233.

[12] *Id.* at 235.

other side of the transaction that arose from a relationship of trust and confidence between the parties thereto.[13] Chiarella was neither an employee, officer, nor director of any of the companies in whose stock he traded. He worked for Pandick Press, which itself was not an agent of any of those companies. Pandick worked for acquiring companies; not the takeover targets in whose stock Chiarella traded. He therefore had no duty to disclose to those with whom he traded.[14]

Three years later, in *Dirks v. SEC*,[15] the Supreme Court reaffirmed and refined *Chiarella*'s sharp limitation of the insider trading prohibition. Raymond Dirks, who was a securities analyst, began investigating Equity Funding of America after receiving a tip that it was engaged in widespread fraudulent corporate practices from Ronald Secrist, a former officer of Equity Funding. Dirks passed the results of his investigation to the SEC and the Wall Street Journal, but also discussed his findings with his clients. A number of those clients sold their holdings of Equity Funding securities before any public disclosure of the fraud, thereby avoiding substantial losses. After the fraud became public and Equity Funding went into receivership, the SEC charged that Dirks had violated the federal insider trading prohibition by repeating the allegations of fraud to his clients.

Under the *Texas Gulf Sulphur* equal access to information standard, tipping of the sort at issue in *Dirks* presented no conceptual problems. The tippee has access to information unavailable to those with whom he traded and, as such, is liable. After *Chiarella*, however, the tipping problem was more complex. Neither Dirks nor his customers were agents, officers, or directors of Equity Funding. Nor did they have any other form of special relationship of trust and confidence with those with whom they traded. They were pure strangers.

In reversing Dirk's censure, the Supreme Court reaffirmed its rejection of the equal access standard:

> We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information "was not [the corporation's] agent, ... was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence." Not to require such a fiduciary relationship, we recognized, would "depar[t] radically from the established doctrine that duty arises from a specific relationship between two parties" and would amount to "recognizing a general duty between all

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[13] *Id.* at 230.

[14] *Id.* at 232-33.

[15] 463 U.S. 646 (1983).

> participants in market transactions to forgo actions based on material, nonpublic information."[16]

Recognizing that the *Chiarella* formulation posed problems for tipping cases, the court held that tipping could violate the insider trading prohibition, but further held that a tippee's liability is derivative of the tipper's, "arising from his role as a participant after the fact in the insider's breach of a fiduciary duty."[17] A tippee therefore can be held liable only when the tipper breached a fiduciary duty by disclosing information to the tippee, and the tippee knows or has reason to know of the breach of duty.[18]On the *Dirks* facts, this formulation precluded imposition of liability. To be sure, Secrist was an officer and, hence, a fiduciary of Equity Funding. But the mere fact that an insider tips nonpublic information is not enough under *Dirks*. What *Dirks* proscribes is not merely a breach of confidentiality by the insider, but rather a breach of the duty of loyalty imposed on all fiduciaries to avoid personally profiting from information entrusted to them.[19] Looking at objective criteria, courts must determine whether the insider personally benefited, directly or indirectly, from his disclosure.[20] Secrist tipped off Dirks in order to bring Equity Funding's misconduct to light, not for any personal gain. Absent the requisite personal benefit, liability could not be imposed.[21]

Just as there had been nothing historically or doctrinally inevitable about *Texas Gulf Sulphur*'s imposition of the equal access standard, there equally was nothing inevitable about the Supreme Court's rejection of that standard. The equal access standard was consistent with a trend towards affirmative disclosure obligations and away from *caveat emptor* that was sweeping across a broad swath of the common law. In rejecting this trend, Justice Powell arguably shifted the focus of insider trading liability from deceit to agency, a point that becomes especially significant later in our analysis.[22] Nothing in the text of the statute or the rule explicitly mandated that shift.

IV. The Misappropriation Theory Emerges

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[16] *Id.* at 654-55.

[17] *Id.* at 659.

[18] *Id.* at 660.

[19] *Id.* at 662.

[20] *Id.*

[21] *Id.* at 666-67.

[22] A. C. Pritchard, *United States v. O'Hagan: Agency Law And Justice Powell's Legacy For The Law Of Insider Trading*,78 BOS. UNIV. L. REV. 13 (1998).

After *Chiarella* and *Dirks*, the SEC began advocating a new theory of insider trading liability that came to be called "misappropriation." Its origins are commonly (but incorrectly) traced to Chief Justice Burger's *Chiarella* dissent. Burger contended that the way in which the inside trader acquires the nonpublic information on which he trades could itself be a material circumstance that must be disclosed to the market before trading. Accordingly, he argued, "a person who has misappropriated nonpublic information has an absolute duty [to the persons with whom he trades] to disclose that information or to refrain from trading."[23] The majority declined to address Burger's argument, because it had not been presented to the jury and thus could not sustain a criminal conviction.[24]

The way was thus left open for the SEC to urge the lower courts to adopt the misappropriation theory as an alternative basis of insider trading liability. In *United States v. Newman,*[25] employees of an investment bank misappropriated confidential information concerning proposed mergers involving clients of the firm. As had been true of Vincent Chiarella, the Newman defendants' employer worked for prospective acquiring companies, while the trading took place in target company securities. As such, the Newman defendants owed no fiduciary duties to the investors with whom they traded. In this instance, moreover, neither the investment bank nor in its clients traded in the target companies' shares contemporaneously with the defendants.

Unlike Chief Justice Burger's *Chiarella* dissent, the Second Circuit did not assert that the Newman defendants owed any duty of disclosure to the investors with whom they traded or had defrauded them. Instead, the court held that by misappropriating confidential information for personal gain, the defendants had defrauded their employer and its clients and that that fraud sufficed to impose insider trading liability on the defendants with whom they traded.[26]

Like the traditional disclose or abstain rule, the misappropriation theory thus required a breach of fiduciary duty before trading on inside information became unlawful.[27] Under the misappropriation theory, however, the defendant need not owe a duty either to the investor with whom he traded or to the issuer of the traded securities. Instead, the misappropriation theory applied when the inside

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[23] Chiarella v. United States, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting).

[24] *Id.* at 236.

[25] 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

[26] *Id.* at 17.

[27] *See* SEC v. Switzer, 590 F. Supp. 756, 766 (W.D. Okla. 1984) (not unlawful to trade on the basis of inadvertently overheard information).

trader violated a fiduciary duty owed to the source of the information.[28] If the misappropriation theory had been available against Chiarella, for example, his conviction could have been upheld based on the breach of the duty he owed Pandick Press.

A. Why the SEC Pushed the Misappropriation Theory

The misappropriation theory thus became the vehicle by which the SEC sought to recapture as much as possible of the ground it had lost in *Chiarella* and *Dirks*. A former SEC Commissioner admitted as much, acknowledging that the misappropriation theory was "merely a pretext for enforcing equal opportunity in information."[29]

The SEC's support for the misappropriation theory likely was not accidental.[30] During the 1980s, the Commission embarked upon a limited program of deregulating the securities markets. Among other things, it adopted a safe harbor for projections and other soft data, the shelf registration rule, the integrated disclosure system, and expanded the exemptions from registration under the Securities Act. The deregulatory trend motivated one long-time critic of the SEC to compliment the Commission for being "well on the road toward a sensible disclosure system with much of the dead wood, idiosyncrasies, overregulation, and overdrafting eliminated."[31] At about the same time, however, the SEC adopted a vigorous enforcement campaign against insider trading. Not only did the number of cases increase substantially, but also the Commission adopted a "big bang" approach under which it focused on high visibility cases that would produce substantial publicity. In part, this may have been due to an increase in the frequency of insider trading, but one suspects the Commission's renewed interest in insider trading was motivated in large measure by a desire to preserve its budget during an era of deregulation and spending restraint. By virtue of the misappropriation theory, the Commission restored much of the

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[28] *E.g.*, United States v. Carpenter, 791 F.2d 1024, 1028-29 (2d Cir. 1986), *aff'd on other grounds*, 484 U.S. 19 (1987).

[29] Charles C. Cox & Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO ST. L.J. 353, 366 (1988).

[30] *See* Bainbridge, *supra* note 4, at 1246-51; see also MICHAEL P. DOOLEY, FUNDAMENTALS OF CORPORATE LAW 816-857 (1995); JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY (1991).

[31] Homer Kripke, *Has the SEC Taken All the Dead Wood Out of Its Disclosure System?,* 38 BUS. LAW. 833 (1983).

prohibition's pre-*Chiarella* breadth and thereby ensured that its budget-justifying enforcement program would continue unimpeded.

By this point, moreover, the insider trading prohibition had come to benefit important interest groups. The post-*Chiarella* insider trading rules have been supported and driven in large part by market professionals, a cohesive and politically powerful interest group, which the post-*Chiarella* regime effectively insulates from insider trading liability. Only insiders and quasi-insiders such as lawyers and investment bankers have a greater degree of access to nonpublic information that might affect a firm's stock price than do market professionals. By basing insider trading liability on breach of fiduciary duty, and positing that the requisite fiduciary duty exists with respect to insiders and quasi-insiders but not with respect to market professionals, the prohibition protects the latter's ability to profit from new information about a firm.

B. The Poor Fit Between Insider Trading and Securities Fraud

The emergence of the misappropriation theory highlighted the increasingly anomalous nature of the insider trading prohibition in the overall scheme of securities regulation. Both Securities Exchange Act §10(b) and Rule 10b-5 thereunder sweep broadly, capturing "any" fraudulent or manipulative conduct "in connection with" the purchase or sale of "any" security. Nonetheless, the Supreme Court has warned against expanding the concept of securities fraud beyond that which the words of the statute will reasonably bear.[32] Once courts began accepting the misappropriation theory, that warning took on special significance. From a strict textualist perspective, the validity of the misappropriation theory appeared to depend upon whether (1) the deceit, if any, worked by the misappropriator on the source of the information constitutes deception as the term is used in §10(b) and Rule 10b-5 and (2) any such deceit is deemed to have occurred "in connection with" the purchase or sale of a security.

In *United States v. Bryan*, the Fourth Circuit defined fraud—as the term is used in §10(b) and Rule 10b-5—"as the making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose."[33] So defined, fraud is present in a misappropriation case only in a technical and highly formalistic sense. Although a misappropriator arguably deceives the source of the information, any such deception is really quite inconsequential. The source of the information presumably is injured, if at all, not by the deception, but by the

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[32] United States v. Bryan, 58 F.3d 933, 945 (4th Cir. 1995) (citing Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994)).

[33] *Id.* at 946.

conversion of the information by the misappropriator for his own profit. Hence, it is the breach of fiduciary duty, if any, by the misappropriator that is truly objectionable, while any deception is purely incidental. So understood, the misappropriation theory appears to run afoul of the Supreme Court's holding in *Santa Fe* that a mere breach of duty cannot give rise to Rule 10b-5 liability.[34]

In *Santa Fe*, the court held that Rule 10b-5 did not reach claims "in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary."[35] But this is the very essence of the complaint made in insider trading cases. The court also held that extension of Rule 10b-5 to breaches of fiduciary duty was unjustified in light of the state law remedies available to plaintiffs.[36] Insider trading plaintiffs likewise have state law remedies available to them.[37] Granted, those remedies vary from state to state and are likely to prove unavailing in many cases, but the same was true of the state law remedy at issue in *Santa Fe*.[38] Finally, the court expressed reluctance "to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden."[39] But this is precisely what the federal insider trading prohibition did. *Santa Fe* thus is a serious doctrinal problem for proponents of an insider trading prohibition grounded in securities fraud.[40]

Santa Fe was not the only doctrinal challenge to the misappropriation theory. In *Central Bank of Denver v. First Interstate Bank*,[41] the Supreme Court held that there was no implied private right of action against those who aid and abet violations of Rule 10b-5. *Central Bank* thus substantially limited the scope of secondary liability under the rule, at least insofar as private party causes of action are concerned. For our purposes, however, the case is more significant for its methodology than its holding. The court held that the scope of conduct prohibited by §10(b) (and thus Rule 10b-5) is controlled by the text of the statute. Where the

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[34] Santa Fe Industries v. Green, 430 U.S. 462 (1977). The federalism implications of insider trading regulation are discussed in Bainbridge, *supra* note 4, at 1258-61; Richard W. Painter et al., Don't Ask, Just Tell: Insider Trading after United States v. O'Hagan, 84 Va. L. Rev. 153, 174-86 (1998).

[35] *Santa Fe*, 430 U.S. at 477.

[36] *Id.* at 478.

[37] Bainbridge, *supra* note 4, at 1218-27.

[38] *Id.* at 1259.

[39] *Santa Fe*, 430 U.S. at 479.

[40] *See Bryan*, 58 F.3d at 946, 949.

[41] 511 U.S. 164 (1994).

plain text does not resolve some aspect of the Rule 10b-5 cause of action, courts must "infer 'how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision of the 1934 Act.'"[42]

Applying the *Central Bank* standard, the Eighth Circuit, in *United States v. O'Hagan*, interpreted the statutory prohibition of fraud created by a §10(b) narrowly to exclude conduct constituting a "mere breach of a fiduciary duty," instead capturing only conduct constituting a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose.[43] Because the Eighth Circuit believed the misappropriation theory permits the imposition of §10(b) liability based upon a breach of fiduciary duty without any such deception, it held that the theory was inconsistent with the plain statutory text of §10(b) and, accordingly, invalid as per *Central Bank*.[44]

The Eighth Circuit further invoked *Central Bank* to strictly construe the statutory limitation that the requisite deception be committed "in connection with" a securities transaction,[45] which requirement the court contended the misappropriation theory rendered "nugatory."[46] Specifically, the court held that §10(b) reaches "only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors."[47] Absent such a limitation, the court opined, §10(b) would be transformed "into an expansive 'general fraud-on-the-source theory' which seemingly would apply infinite number of trust relationships."[48] Such an expansive theory of liability, the court further opined, could not be justified by the text of statute.[49] In the typical

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[42] *Id.* at 178 (quoting Musick, Peeler & Garrett v. Employers Ins., 508 U.S. 286 , 294 (1993)). The court admits this is an "awkward task." Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350, 357 (1991). Justice Scalia put it more colorfully: "We are imagining here." *Id.* at 360. Central Bank constrained this imaginative process by requiring courts to "use the express causes of action in the securities acts as the primary model for the §10(b) action." *Central Bank*, 511 U.S. at 178.

[43] U.S. v. O'Hagan, 92 F.3d 612, 617-18 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

[44] *Id.*

[45] *Id.* at 618.

[46] *Id.* at 617.

[47] *Id.* In *Bryan*, the Fourth Circuit similarly opined §10(b) is primarily concerned with deception of purchasers and sellers of securities, and at most extends to fraud committed against other persons closely linked to, and with a stake in, a securities transaction. 58 F.3d at 946.

[48] *O'Hagan*, 92 F.3d at 619 (quoting *Bryan*, 58 F.3d at 950).

[49] *Id.*

misappropriation case, of course, the source of the information is not the affected purchaser or seller. Often the source is not even a contemporaneous purchaser or seller and frequently has no state in any affected securities transaction. Even assuming the misappropriator has deceived the source of the information, one thus must stretch the phrase “in connection with” pretty far in order to bring that fraud within the statute’s ambit. As the Fourth Circuit put it: “The misappropriation of information from an individual who is in no way connected to, or even interested in, securities is simply not the kind of conduct with which the securities laws, as presently written, are concerned.”[50]

The Eighth and Fourth Circuits’ interpretation of §10(b) had much to commend it. The courts carefully considered the Supreme Court’s relevant precedents, especially *Santa Fe* and *Central Bank*. At least insofar as the misappropriation theory imposes liability solely on the basis of a breach of fiduciary duty to the source of the information, without any requirement that the alleged perpetrator have deceived the persons with whom he traded or other market participants, the theory ran afoul of those precedents.

Yet, these cases potentially challenged not just the misappropriation theory but the entirety of the insider trading prohibition. Although the Fourth Circuit was careful to opine that *Bryan* left intact both the disclose or abstain theory of liability and tipping liability thereunder, arguably this was not the case. The duty at issue in tipping cases is not a duty to disclose, but rather, a duty to refrain from self-dealing in confidential information owed by the tipper to the source of the information. As such, tipping is subject to the same line of attack as the *Bryan* court invoked against the misappropriation theory. Even the basic disclose or abstain theory of liability was called into question by *Bryan*. Granted, insider trading in violation of the disclose or abstain rule involves an element of deception. By definition, the defendant has failed to disclose nonpublic information before trading. The nondisclosure argument is not a very powerful explanation for insider trading liability, however. Persons subject to the disclose or abstain theory often are also subject to a duty of confidentiality, which precludes them from disclosing the information. As we have seen, the insider trading prohibition thus becomes a rule to abstain from trading, rather than a rule requiring disclosure or abstention. In other words, given that defendant had no right to disclose, it is the failure to abstain from trading, rather than the nondisclosure, which is the basis for imposing liability. The inexorable logic of both *Bryan* and the Eighth Circuit’s *O’Hagan* opinion thus called into question

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[50] 58 F.3d at 950.

not just the misappropriation theory, but the entire federal insider trading prohibition.[51]

V. The Policy Basis For Regulating Insider Trading

Just as the development of the misappropriation theory exposed the doctrinal anomalies inherent in the insider trading prohibition, it also exposed the lack of a coherent policy justification for the prohibition. Securities fraud is concerned with protection of investors and preservation of investor confidence in the integrity of the securities markets.[52] Yet, as the Fourth and Eighth Circuit's analyses implied, the insider trading prohibition had come to be more about theft of information than investor protection.[53]

Under the post-*Chiarella* framework, investors' rights varied widely depending on the identity of the trader, the nature of the inside information, and the source of that information. Consider *United States v. Carpenter*[54]. R. Foster Winans wrote the Wall Street Journal's "Heard on the Street" column, a daily report on various stocks that is said to affect the price of the stocks discussed. Journal policy expressly treated the column's contents prior to publication as confidential information belonging to the newspaper. Despite that rule, Winans agreed to provide several co-conspirators with prepublication information as to the timing and contents of future columns. His fellow conspirators then traded in those stocks based on the expected impact of the column on the stocks' prices, sharing the profits.

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[51] Put another way, the nondisclosure argument is circular. As *Chiarella* made clear, and *Dirks* affirmed, not all failures to disclose are fraudulent. Rather, a nondisclosure is actionable only if the trader is subject to a duty to disclose. In turn, a duty to disclose exists only where the trader is subject to a fiduciary duty to refrain from self-dealing in confidential information. Absent such a fiduciary duty, insider trading simply is not fraudulent. Once again, this leaves the disclose or abstain rule subject to the same line of attack as was adopted by the Fourth and Eighth Circuits.

[52] *See, e.g.,* Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 173 (1994) ("the broad congressional purposes behind the [securities laws are] to protect investors from false and misleading practices that might injure them").

[53] In a telling passage of his partial dissent to a leading Second Circuit opinion endorsing and fleshing out the misappropriation theory, Judge Winter had acknowledged that the misappropriation theory lacked "any obvious relationship" to the statutory text of §10(b) because "theft rather than fraud or deceit" had become "the gravamen of the prohibition." United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., concurring in part and dissenting in part), *cert. denied*, 503 U.S. 1004 (1992).

[54] 791 F.2d 1024 (2d Cir. 1986), aff'd, 484 U.S. 19 (1987).

Any duties Winans owed in this situation ran to an entity that had neither issued the securities in question nor even participated in stock market transactions. What Winans' breach of his duties to the Wall Street Journal has to do with the federal securities laws is not immediately apparent. The incongruity of the misappropriation theory becomes even more apparent when one considers that its logic suggests that the Wall Street Journal could lawfully trade on the same information used by Winans. If we are really concerned with protecting investors and maintaining their confidence in the market's integrity, the inside trader's identity ought to be irrelevant. As *Texas Gulf Sulphur* recognized, from the investors' point of view, insider trading is a matter of concern because they have traded with someone with superior access to information. From the investor's perspective, it does not matter whether it is Winans or the Journal on the opposite side of the transaction. Both have greater access to the relevant information than do investors.

The logic of the misappropriation theory also suggests that Winans would not have been liable if the Wall Street Journal had authorized his trades. In that instance, his trades would not have constituted an improper conversion of nonpublic information and the essential breach of fiduciary duty would not be present. Again, however, from an investor's perspective, it would not seem to matter whether Winans' trades were authorized or not.

In sum, if investor protection or confidence in the market were the real issues, one would be hard-pressed to defend the pre-*O'Hagan* state of the law. An expansive version of the old equal access test seems far better-suited to advancing those values, but it (supposedly) expired in *Chiarella*. Something else must be going on.

Pre-*O'Hagan*, there was a growing consensus that the federal insider trading prohibition is more easily justified as a means of protecting property rights in information than as a way of protecting investors.[55] Consider the prototypical insider trading transaction, in which an insider trades in her employer's stock on the basis of information learned solely because of her position with the firm. There is no avoiding the necessity of assigning the property right to either the corporation or the inside trader. A rule allowing insider trading assigns the

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[55] *See* Bainbridge, *supra* note 4, at 1252, and authorities cited in id. at 1252 n.266. The question for most scholars no longer was whether some form of insider trading regulation is necessary and appropriate to protect property rights in nonpublic information, but whether we should make a federal case of it. *See* Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT ECON. REV. 123, 171 (1998) ("Misappropriation of information is wrong, but we should not make a federal case out of it.").

property right to the insider, while a rule prohibiting insider trading assigns it to the corporation.

The rationale for assigning the property right to the firm is precisely the same as the rationale for prohibiting patent infringement or theft of trade secrets: protecting the economic incentive to produce socially valuable information. As the theory goes, the readily appropriable nature of information makes it difficult for the developer of a new idea to recoup the sunk costs incurred in developing it.[56] If an inventor develops a better mousetrap, for example, he cannot profit on that invention without selling mousetraps and thereby making the new design available to potential competitors. Assuming both the inventor and his competitors incur roughly equivalent marginal costs to produce and market the trap, the competitors will be able to set a market price at which the inventor likely will be unable to earn a return on his sunk costs. *Ex post*, the rational inventor should ignore his sunk costs and go on producing the improved mousetrap. *Ex ante*, however, the inventor will anticipate that he will be unable to generate positive returns on his up-front costs and therefore will be deterred from developing socially valuable information. As Judge Ralph Winter explained in his separate opinion in *United States v. Chestman*:

> Information is ... expensive to produce, and, because it involves facts and ideas that can be easily photocopied or carried in one's head, there is a ubiquitous risk that those who pay to produce information will see others reap the profit from it. Where the profit from an activity is likely to be diverted, investment in that activity will decline. If the law fails to protect property rights in commercial information, therefore, less will be invested in generating such information.[57]

Accordingly, society provides incentives for inventive activity by using the patent system to give inventors a property right in new ideas. By preventing competitors from appropriating the idea, the patent allows the inventor to charge monopolistic prices for the improved mousetrap, thereby recouping his sunk costs. Trademark, copy-right, and trade secret law all are justified on similar grounds.

Granted, this argument may not provide quite as compelling a justification for the insider trading prohibition as it does for the patent system. Legalizing insider trading likely would have a much smaller impact on the corporation's incentive to develop new information than would, say, legalizing patent infringement. It seems plausible, however, that insider trading will have at least

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[56] ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 119-28 (2d ed. 1997).

[57] 947 F.2d 551, 576-77 (2d Cir. 1991) (Winter, J., dissenting in part), *cert. denied*, 503 U.S. 1004 (1992).

some impact on the incentive to produce new information. Again, Judge Winter explains:

> [I]nsider trading creates a risk that information will be prematurely disclosed by such trading, and the corporation will lose part or all of its property in that information. Although trades by an insider may rarely affect market price, others who know of the insider's trading may notice that a trader is unusually successful, or simply perceive unusual activity in a stock and guess the information and/or make piggyback trades. A broker who executes a trade for an [insider] may well draw relevant conclusions. Or, as in the instant matter, the trader ... may tell his or her broker about the inside information, who may then trade on his or her account, on clients' accounts, or may tell friends and relatives. One inside trader has publicly attributed his exposure in part to the fact that the bank through which he made trades piggybacked on the trades, as did the broker who made the trades for the bank. Once activity in a stock reaches an unusual stage, others may guess the reason for the trading--the corporate secret. Insider trading thus increases the risk that confidential information acquired at a cost may be disclosed. If so, the owner of the information may lose its investment.[58]

Even if one is skeptical that insider trading poses the sort of threats Winter identifies, the affirmative case for assigning the property right to the corporation is demonstrably stronger than the one for assigning it to the insider, as I have explained elsewhere.[59] The law therefore should assume (although the assumption sometimes may be wrong) that assigning the property right to the firm maximizes the social incentives for the production of valuable new information.

There are essentially two ways of assigning a property right to information: allowing the owner to enter into transactions without disclosing the information or prohibiting others from using the information. In effect, the federal insider trading prohibition vests a property right of the latter type in the owner of nonpublic information. To be sure, enforcement of the insider trading prohibition differs rather dramatically from enforcement of, say, trespassing laws. In context, however, the prohibition's enforcement mechanisms are not inconsistent with a property rights analysis. Where public policy argues for giving someone a property right, but the costs of enforcing such a right would be excessive, the state often uses its regulatory powers as a substitute for granting a property right. Insider trading poses just such a situation. Private enforcement of the insider trading laws is rare and usually parasitic on public enforcement proceedings.[60]

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[58] *Id.* at 577 (footnote and citations omitted).

[59] Bainbridge, *supra* note 4, at 1255-56.

[60] Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 15-17 (1980).

Indeed, the very nature of insider trading makes public regulation essential precisely because private enforcement is almost impossible. The insider trading prohibition's regulatory nature thus need not preclude a property-rights-based analysis.

In fact, there were striking doctrinal parallels between insider trading law pre-*O'Hagan* and other forms of property rights in information. Using another's trade secret is actionable only if taking the trade secret involved a breach of fiduciary duty, misrepresentation, or theft, for example, which was "an equally apt summary of the law of insider trading after *Chiarella* and *Dirks*."[61] In light of such parallels, Winter speculated that the property rights rationale explained both the Supreme Court's decisions in *Chiarella* and *Dirks* and the Second Circuit's adoption of the misappropriation theory.[62]

Perhaps, it is thus not surprising that many aspects of the pre-*O'Hagan* prohibition were more consistent with the property rights justification for the prohibition than they were with a securities fraud-based justification. The basic function of a securities fraud regime is to ensure timely disclosure of accurate information to investors. Yet, the insider trading prohibition did not lead to increased disclosure. Consider the classic disclose or abstain rule as the Second Circuit pronounced it in *Texas Gulf Sulphur*: The rule's name was something of a misnomer, of course. The Second Circuit presumably phrased the rule in terms of disclosure because a key element of an omission case under Rule 10b-5 is that the defendant owed a duty of disclosure to the investor on the other side of the transaction. As a practical matter, however, disclosure was rarely an option. In *Texas Gulf Sulphur*, for example, the company had no affirmative duty to disclose the ore strike. As the Second Circuit correctly noted, the timing of disclosure was a matter for the business judgment of corporate managers, subject to any affirmative disclosure requirements imposed by the stock exchanges or the SEC.[63] In this case, moreover, a valuable corporate purpose was served by delaying disclosure: confidentiality prevented competitors from buying up the mineral rights and kept down the price landowners would charge for them. The company therefore had no duty to disclose the discovery, at least up until the time that the land acquisition program was completed. Given that the corporation had no duty

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[61] DOOLEY, *supra* note 30, at 776.

[62] United States v. Chestman, 947 F.2d 551, 578 (2d Cir. 1991) (Winter, J., dissenting in part), *cert. denied*, 503 U.S. 1004 (1992).

[63] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir.), *cert. denied*, 394 U.S. 976 (1968).

to disclose, and had decided not to disclose the information, the insiders' fiduciary duties to the corporation precluded them disclosing it for personal gain.

Disclosure by an insider who wishes to trade thus was only feasible if there was no legitimate corporate purpose for maintaining secrecy. These situations, however, presumably are relatively rare—it is hard to imagine many business developments that can be disclosed immediately without working some harm to the corporation. In most cases, the disclose or abstain rule really does not provide the insider with a disclosure option. Instead, the rule collapses into a rule of abstention. Accordingly, as a former SEC Commissioner admitted, "the insider trading rules probably do not result in more information coming into the market: The 'abstain or disclose' rule for those entrusted with confidential information usually is observed by abstention."[64]

It is also telling that many of the prohibition's doctrinal oddities make sense if protection of property rights is the true policy goal.[65] Consider, for example, the apparent incongruity that Winans could be held liable for trading on information about the Wall Street Journal's "Heard on the Street," but the Journal could have lawfully traded on the same information. As we saw above, this result makes no sense from a traditional securities law perspective. From a property rights perspective, however, the result in *Carpenter* makes perfect sense: Because the information belonged to the Journal, it should be free to use the information as it saw fit, while Winans' use of the same information amounted to a theft of property owned by the Journal.

A property rights-based approach also helps make sense of a couple of aspects of *Dirks* that are quite puzzling when approached from a securities fraud-based perspective. One is the court's solicitude for market professionals. After *Dirks*, market analysts were essentially exempt from insider trading liability with respect to nonpublic information they develop because they usually owe no fiduciary duty to the firms they research. *Dirks* thus essentially assigned the property right to such information to the market analyst rather than to the affected

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[64] Cox & Fogarty, *supra* note 29, at 353.

[65] To be sure, not all aspects of the federal prohibition can be so explained. For example, because property rights generally include some element of transferability, it may seem curious that federal law at least in some circumstances does not allow the owner of nonpublic information to authorize others to use it for their own personal gain. *See, e.g.,* 17 C.F.R. §240.14e-3(d) (tender offeror may not divulge its takeover plans to anyone likely to trade in target stock). This does not undermine the general validity of the property rights justification. Rather, if protection of property rights is taken as a valid public-regarding policy basis for the prohibition, it gives us a basis for criticizing departures from that norm.

corporation. From a disclosure-oriented perspective, this is puzzling—the analyst and/or his clients will trade on the basis of information other investors lack. From a property perspective, however, the rule is justifiable because it encourages market analysts to expend resources to develop socially valuable information about firms and thereby promote market efficiency.[66]

An even more significant puzzle, which also becomes more easily explicable from a property rights perspective, was the Supreme Court's failure in *Chiarella* and *Dirks* to precisely define the basis upon which liability was to be imposed. Did it suffice to show that a fiduciary relationship existed between the inside trader and those with whom she traded (or the source of the information in the case of the misappropriation theory)? Or was it necessary to show that the trade breached a specific fiduciary duty arising out of such a relationship? If the latter, what duty was the relevant one? The court was never very clear on this issue, but a number of passages in *Dirks* implied that it was a breach of the fiduciary duty against self-dealing—not merely the existence of a fiduciary relationship or a breach of a duty of confidentiality—that was at issue. The court, for example, described the elements of an insider trading violation as: "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure."[67] Another passage likewise describes insider trading liability as arising from "the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"[68] Yet, another noted that insiders are "forbidden by their fiduciary relationship from using undisclosed corporate information for their personal gain."[69] The focus in each instance is on the duty to refrain from self-dealing. From a disclosure oriented approach, in which maximizing disclosure is the principal policy goal, such a focus makes no sense, because requiring such a breach limits the class of cases in which disclosure is made. In contrast, from a property rights perspective, these passages make perfect sense, because they focus attention on the basic issue of whether the insider had converted information belonging to the corporation.

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[66] *See* MACEY, *supra* note 30, at 36.

[67] Dirks v. SEC, 463 U.S. 646, 653 (1983) (quoting Chiarella v. United States, 445 U.S. 222, 227 (1980)).

[68] *Id.* at 654 (quoting In re Merrill Lynch, Pierce, Fenner & Smith, Inc., 43 S.E.C. 933, 936 (1968)).

[69] *Id.* at 659.

VI. O'Hagan

In *United States v. O'Hagan*,[70] Supreme Court revisited the post-*Chiarella* insider trading prohibition in order to determine the validity of the misappropriation theory. James O'Hagan was a partner in the Minneapolis law firm of Dorsey & Whitney. In July 1988, Grand Metropolitan PLC (Grand Met) retained Dorsey & Whitney in connection with its planned takeover of Pillsbury Company. Although O'Hagan was not one of the lawyers on the Grand Met project, he learned of their intentions and began buying Pillsbury stock and call options on Pillsbury stock. When Grand Met announced its tender offer in October, the price of Pillsbury stock rose to nearly $60 per share. O'Hagan then sold his Pillsbury call options and common stock, making a profit of more than $4.3 million. O'Hagan subsequently was indicted and convicted on various charges, the most pertinent of which for our purposes was that he violated §10(b) and Rule 10b-5 by trading on misappropriated nonpublic information.[71] On appeal, the Eighth Circuit reversed O'Hagan's conviction, becoming the second court of appeals (joining the Fourth Circuit) to reject the misappropriation theory. The Supreme Court took cert to resolve the resulting circuit split.

The court now had an opportunity to rethink the entire problem. How did the federalism principles of *Santa Fe* apply to insider trading? What about the statutory interpretation methodology of *Central Bank*? Unfortunately, the court's answers to these questions managed to (1) create new and potentially challenging doctrinal problems; (2) exacerbate the doctrinal tensions between the prohibition on the one hand and both *Central Bank* and *Santa Fe* on the other, and (3) weaken the protections the prohibition provides owners of nonpublic information. In most respects, the court left Rule 10b-5 in a worse state than it found it. end

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[70] 521 U.S. 642 (1997), *rev'g*, 92 F.3d 612 (8th Cir. 1995).

[71] O'Hagan was also indicted for violations of Rule 14e-3, which proscribes insider trading in connection with tender offers, and the federal mail fraud and money laundering statutes. The Eighth Circuit overturned O'Hagan's convictions under those provisions. As to Rule 14e-3, the court held that the SEC lacked authority to adopt a prohibition of insider trading that does not require a breach of fiduciary duty. *O'Hagan*, 92 F.3d at 622-27. As to O'Hagan's mail fraud and money laundering convictions, the Eighth Circuit also reversed them on grounds that the indictment was structured so as to premise the charges under those provisions on the primary securities fraud violations. *Id.* at 627-28. Accordingly, in view of the court's reversal of the securities fraud convictions, the latter counts could not stand either. The Supreme Court reversed on all points, reinstating O'Hagan's convictions under all of the statutory violations charged in the indictment. United States v. O'Hagan, 521 U.S. 642 (1997).

A. The Holding

The Supreme Court reversed the Eighth Circuit, thereby confirming that the misappropriation theory is a valid basis on which to impose insider trading liability. The majority (per Justice Ginsburg) acknowledged that misappropriators such as O'Hagan have no disclosure obligation running to the persons with whom they trade. Instead, it grounded liability under the misappropriation theory on deception of the source of the information. A fiduciary's undisclosed use of information belonging to his principal, without disclosure of such use to the principal, for personal gain constitutes fraud in connection with the purchase or sale of a security and thus violates Rule 10b-5.

Although the court thus rejected the Fourth and Eighth Circuits' position, the version of the misappropriation theory it endorsed differed from that which had been crafted by the lower courts. The majority explained that its version of the misappropriation theory addresses the use of "confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[72] Accordingly, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information."[73] Someone thus can be held liable under this version misappropriation theory only where they have deceived the source of the information by failing to disclose their intent to trade on the basis of the information disclosed by the source. This requirement follows, the majority opined, from the statutory requirement that there be a "deceptive device or contrivance" used "in connection with" a securities transaction.[74] The Supreme Court thus rejected Chief Justice Burger's argument in *Chiarella* that the misappropriation theory created disclosure obligation running to those with whom the misappropriator trades.[75] Instead, it is the failure to disclose one's intentions to the source of the information that constitutes the requisite disclosure violation under the *O'Hagan* version of the misappropriation theory.

O'Hagan posed at least as many new questions as it answered old ones. Among these are:

Liability for brazen misappropriators? The *O'Hagan* majority made clear that disclosure to the source of the information is all that is required under Rule 10b-5. If a brazen misappropriator discloses his trading plans to the source, and

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[72] *Id.* at 652.

[73] *Id.*

[74] *Id.* at 653.

[75] *Id.* at 654 n.6.

then trades on that information, Rule 10b-5 is not violated.[76] As we shall see, this is an odd result that jibes with neither the property rights nor the securities fraud rationale for regulating insider trading.

Liability for authorized trading? Suppose, for example, a takeover bidder authorized an arbitrageur to trade in target company's stock on the basis of material nonpublic information about the perspective bidder's intentions. Warehousing of this sort is proscribed by Rule 14e-3, but only insofar as the information relates to a perspective tender offer. Whether such trading in a non-tender offer context violated Rule 10b-5 was unclear. The *O'Hagan* majority at least implicitly validated authorized trading of this sort. It approvingly quoted, for example, counsel for the United States' comment that "to satisfy the common law rule the trustee may not use the property that [has] been entrusted [to] him, there would have to be consent."[77]

The fiduciary relationship requirement: Does a duty to disclose to the source of the information arise before trading in all fiduciary relationships? Consider ABA Model Rule of Professional Conduct 1.8(b), which states: "A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation ...." Does a lawyer's use of confidential client information for insider trading purposes always operate to the client's disadvantage? If not, O'Hagan did not violate §10(b). The *O'Hagan* majority simply ignored this problem.

Criminal or civil?: In rejecting the Eighth Circuit's argument that Rule 10b-5 is primarily concerned with deception of market participants, the majority noted that the discussion in *Central Bank* upon which the Eighth Circuit relied dealt only with private civil litigation under §10(b). The court then went on to discuss its holding in *Blue Chip Stamps* that only actual purchasers or sellers of securities have standing to bring private causes of action under Rule 10b-5.[78] The court concluded: "Criminal prosecutions do not present the dangers the court addressed in *Blue Chip Stamps*, so that decision is 'inapplicable' to indictments for violations of §10(b) and Rule 10b-5."[79] This passage opens the door for

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[76] *Id.* at 655 ("full disclosure forecloses liability under the misappropriation theory ... if the fiduciary discloses to the source that he plans to trade on nonpublic information, there is no 'deceptive device' and thus no §10(b) violation").

[77] *Id.* at 654. Footnote 7 to the majority opinion, however, suggests that on these facts O'Hagan would need approval from both Dorsey & Whitney and Grand Met. *Id.* at 655 n.7.

[78] *Id.* at 664 (discussing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

[79] *Id.* (citations omitted).

misappropriators to argue that *O'Hagan* should be limited to criminal prosecutions, because the majority acknowledged the limitations imposed by *Central Bank* and *Blue Chip Stamps* on private party litigation.

B. Status of Central Bank and Santa Fe

The *O'Hagan* majority essentially orphaned *Central Bank*. Justice Ginsburg largely ignored the statutory text, except for rather glib assertions with respect to the meaning of the phrases "deception" and "in connection with." She likewise ignored the cogent arguments advanced by both the Eighth and Fourth Circuits with respect to the implications of *Central Bank* for the misappropriation theory.[80] Most importantly, she ignored the interpretive methodology expounded in *Central Bank*.[81] One is therefore left to wonder whether the strict textualist approach taken by Central Bank was an aberrational departure from the more policy-sensitive approach that exemplified Supreme Court securities law decisions prior to *Central Bank*.[82]

As to *Santa Fe*, Justice Ginsburg correctly described that case as "underscoring that §10(b) is not an all-purpose breach of fiduciary duty ban; rather it trains on conduct involving manipulation or deception."[83] Instead of acknowledging that insider trading is mainly a fiduciary duty issue, however, she treated it as solely a disclosure issue. It is thus the failure to disclose that one is about to inside trade that is the problem, not the trade itself: "A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain' ... 'dupes' or defrauds the principal."[84] As Justice

[80] To the extent the majority discussed Central Bank's implications for the problem at hand, it focused on dismissing the Eighth Circuit's argument that Central Bank limited Rule 10b-5's regulatory purview to purchasers and sellers. *Id.*

[81] Strikingly, *Central Bank*'s author (Justice Scalia) dissented from the majority's Rule 10b-5 holding, relying on the "unelaborated statutory language." *Id.* at 679.

[82] The majority's interpretation of the phrase "in connection with," as used in §10(b), is especially troubling. Fraudulent conduct having only a slight connection with a securities transaction thus is now within the scope of Rule 10b-5. There has long a risk that Rule 10b-5 will become a universal solvent, encompassing not only virtually the entire universe of securities fraud, but also much of state corporate law. The minimal contacts O'Hagan requires between the fraudulent act and a securities transaction substantially exacerbate that risk. The uncertainty thus created as to Rule 10b-5's parameters fairly raises vagueness and related due process issues.

[83] *O'Hagan*, 521 U.S. at 655.

[84] *Id.* at 653-64.

Ginsburg acknowledged, this approach means that full disclosure must preclude liability.

Granted, insider trading involves deception in the sense that the defendant by definition failed to disclose nonpublic information before trading. As we have seen, however, persons subject to the disclose or abstain theory often are also subject to a state law-based fiduciary duty of confidentiality, which precludes them from disclosing the information. As to them, the insider trading prohibition thus becomes a rule to abstain from trading, rather than a rule requiring disclosure or abstention. Even if such a duty did not exist, moreover, identifying the parties to whom the requisite disclosure must be made presents an insurmountable obstacle in cases involving trading on an impersonal stock exchange. As such, *O'Hagan* collapses the prohibition into a rule that all fiduciaries must abstain from trading on material nonpublic information. In other words, it really is the failure to abstain from trading, rather than the nondisclosure, which is the basis for imposing liability. The nondisclosure thus remains wholly incidental to the violation, which remains a breach of fiduciary duty. *Santa Fe* thus remains a serious obstacle for the misappropriation theory.

Justice Ginsburg may or may not have recognized this problem. In either case, her opinion provides a solution, but only at the expense of gutting *Santa Fe* of its principal meaning. Her majority opinion dismissed *Santa Fe* as a mere disclosure case: "in *Santa Fe Industries*, all pertinent facts were disclosed by the persons charged with violating §10(b) and Rule 10b-5; therefore, there was no deception through nondisclosure to which liability under those provisions could attach."[85] In effect, she has relegated to the side-line (by ignoring) the serious federalism concerns that drove *Santa Fe*.

The conceptual conflict between the Supreme Court's insider trading jurisprudence and its more general Rule 10b-5 precedents thus remained unresolved post-*O'Hagan*. Unfortunately, in the subsequent 10-plus years, the Supreme Court has not returned to the basic problem of defining insider trading. Those tensions thus remain very much alive.

C. O'Hagan *and the Property Rights Rationale*

In this essay, I have not tried to hide the ball—it should be clear by now that I believe the Supreme Court should have used Judge Winter's opinion in *Chestman* as a model for deciding *O'Hagan*. As we have seen, Judge Winter acknowledged that the misappropriation theory lacked any real connection to, or justification under, traditional securities fraud concepts. Instead, as he also

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[85] *Id.* at 655 (citations omitted).

recognized, protection of the source of the information's property rights therein is the strongest justification for a continued prohibition of insider trading. Using language that smacked of path dependence, Judge Winter opined that the technical doctrinal problems posed by the misappropriation theory should be overlooked so as to preserve the policy benefits the theory provided.

The Supreme Court thus should have treated the prohibition's location in the federal securities laws as a historical accident, which has some continuing justification in the SEC's comparative advantage in detecting in prosecuting insider trading on stock markets.[86] The court then should have focused on the problem as one implicating fiduciary duties with respect to property rights in information, rather than deceit or manipulation. The court should have forthrightly acknowledged that this interpretation of the federal insider trading prohibition ran afoul of *Central Bank* and *Santa Fe*. Unfortunately, as the Eighth and Fourth Circuit opinions persuasively demonstrated, there does not appear to be any way of preserving the misappropriation theory—and perhaps the prohibition itself—without running afoul of those precedents.

The court could have justified setting aside those precedents in this context by accepting the full implications of Chief Justice Rehnquist's observation that Rule 10b-5 is "a judicial oak which has grown from little more than a legislative acorn."[87] In other words, the court could have treated the insider trading prohibition as a special case of judge-made federal common law, whose continued existence is justified by prudential considerations rather than either the precise statutory language of §10(b) or doctrinaire federalism.

The majority chose not to do so. Instead, as we have seen, it voluntarily strapped itself into the securities fraud straightjacket. In doing so, its contribution to resolving the doctrinal tension between the insider trading prohibition and its *Central Bank* and *Santa Fe* precedents consisted solely of providing ammunition for those who wish to gut those opinions.

The only remaining question is whether the majority did as much damage to the policy basis of the prohibition as it did to the doctrine. As it turns out, the majority opinion is something of a mixed bag. Both proponents and opponents of the property rights rationale will be able to quote passages indicating support for their position, but neither should take much comfort from *O'Hagan.* The basic

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[86] *See* Bainbridge, *supra* note 4, at 1262-66 (arguing that the SEC has a substantial comparative advantage in detecting and prosecuting insider trading, which makes insider trading a unique form of fiduciary duty violation).

[87] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975).

problem is that the majority appears to have no clearer understanding of the policy issues at stake than it did of the doctrinal ones.

The majority opinion began promisingly enough, with an acknowledgement that confidential information belonging to corporations "qualifies as property."[88] The court's authorized trading dictum also is consistent with the property rights rationale, while being demonstrably inconsistent with traditional securities law-based policy justifications for the insider trading prohibition.[89] There is a general presumption the property rights ought to be alienable. If we are concerned with protecting the source of the information's property rights therein, accordingly, we generally ought to permit the source to authorize others to trade on that information.[90] In contrast, legalizing authorized trading makes little sense if the policy goal is the traditional securities fraud concern of protecting investors and maintaining their confidence in the integrity of the markets. Would an investor who traded with O'Hagan feel any better about doing so if she knew that Dorsey and Whitney had authorized O'Hagan's trades?

The authorized trading dictum has significant, but as yet little-noticed, implications. Query, for example, whether it applies to all insider trading cases or just to misappropriation cases. Suppose that in a classic disclose or abstain case, such as *Texas Gulf Sulphur*, the issuer's board of directors adopted a policy of allowing insider trading by managers. If they did so, the corporation has consented to any such inside trading, which under Justice Ginsburg's analysis appears to vitiate any deception. The corporate policy itself presumably would have to be disclosed, just as broad disclosure respecting executive compensation

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[88] *O'Hagan*, 521 U.S. at 654.

[89] Indeed, one might almost argue that the majority gave too much protection to property rights in information. The logic of the *O'Hagan* majority suggests that any undisclosed use of a principal's property by an agent constitutes the requisite deception. Suppose, for example, O'Hagan had ordered the shares in question by a long distance telephone call to his broker and billed the call to the firm without its knowledge or consent. (The example is taken from Painter et al., *supra* note 34, at 178.) In such a case, there has been a deception that was consummated when the thief bought securities. As such, the thief—by Justice Ginsburg's logic—has used a deceptive device in connection with the purchase of a security and has violated Rule 10b-5, which seems patently absurd.

[90] *See* Stephen M. Bainbridge, *Insider Trading under the Restatement of the Law Governing Lawyers*, 19 J. Corp. L. 1, 37-39 (1993) (noting that mandatory rules may be appropriate in some cases).

is already required,[91] but the implication is that authorized trading should not result in 10b-5 liability under either theory.

The authorized trading dictum might have even broader implications if its logic is extended to Rule 10b-5 generally. Consider, for example, the dictum's implications for a case like *Jordan v. Duff and Phelps, Inc.*,[92] which involved a non-insider trading Rule 10b-5 claim arising out of a merger involving a close corporation. Jordan was a securities analyst who worked for Duff & Phelps, a credit and securities rating firm. Jordan purchased shares in Duff & Phelps pursuant to a shareholders agreement that included, *inter alia*, a mandatory buy back provision triggered by termination of employment, under which a terminated employee would receive book value for his shares. Unbeknownst to Jordan, Duff & Phelps was negotiating a merger with Security Pacific. If effected, shareholders would receive a price considerably in excess of book value. Jordan quit, tendered his stock to the company, received the book value thereof, and later learned that Duff & Phelps was going to be acquired in a leveraged buy-out. Jordan sued under Rule 10b-5, alleging that the failure to disclose the merger negotiations was an omission of a material fact that the company had a duty to disclose. The most interesting aspect, for our purposes, of the resulting opinion is the claim made by Judge Posner's dissent that: "The terms of the stockholder agreement show that there was no duty of disclosure, and since there was no duty there was no violation of Rule 10b-5."[93] In effect, Judge Posner is asserting that the scope of the duty to disclose may be defined by contract. Because the shareholder agreement did not require disclosure, there was no duty to disclose.[94] It is but a short step from that holding to the converse proposition that a party to whom a duty to disclosure is owed may contractually waive that entitlement. The majority (per Judge Easterbrook) agreed with the principle, but thought it inapplicable on the facts:

> It is a violation of duty to steal from the corporate treasury; it is not a violation to write oneself a check that the board has approved as a bonus. We may assume that duties concerning the timing of disclosure by an otherwise-

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[91] Notice that in authorized trading cases that would fall within the misappropriation theory rather than the disclose or abstain rule (i.e., an authorization by the source of market information), neither the source of the information nor the inside trader would have any obligation to disclose to the market or to those with whom the trader transacts. This observation further illustrates the rather tenuous connection between inside trading and securities fraud.

[92] 815 F.2d 429 (7th Cir. 1987), *cert. dismissed*, 484 U.S. 901 (1988).

[93] *Id.* at 444 (Posner, J., dissenting).

[94] *Id.* at 446-47.

> silent firm also may be the subject of contract. Section 29(a) of the Securities Exchange Act of 1934 forbids waivers of the provisions of the Act, and here the critical provision is §10 (b) and the SEC's Rule 10b-5. But a provision must be applicable to be "waived," and the existence of a requirement to speak is a condition of the application of §10(b) to a person's silence during a securities trade. The obligation to break silence is itself based on state law, and so may be redefined to the extent state law permits. But we need not decide how far contracts can redefine obligations to disclose. Jordan was an employee at will; he signed no contract.[95]

Jordan stands in sharp contrast with the widely-shared assumption that the federal securities laws are mandatory, rather than enabling, and thus not subject to contractual opting out. The authorized trading dictum in *O'Hagan*, however, supports the Easterbrook/Posner position. If mere disclosure of trading intentions suffices to foreclose Rule 10b-5 liability, as Ginsburg stated, then consent to trading must likewise foreclose such liability. If consent to trading on a case-by-case basis forecloses liability, blanket (albeit informed) *ex ante* consent should do likewise. In neither case has the source of the information been deceived. If *ex ante* consent would foreclose insider trading liability, the logical implication is that a consensual waiver of a disclosure obligation should also foreclose Rule 10b-5 liability.

I do not propose here to delve more deeply into the thorny doctrinal and policy issues raised by this reading of *O'Hagan*. Instead, it suffices to predict that this reading of the majority opinion will not command widespread acceptance. The misappropriation theory announced in *O'Hagan* is premised on fraud on the source of the information. In *Carpenter*, for example, liability would be premised on the fraud perpetrated on the Wall Street Journal. Acting through appropriate decision making processes, the Journal could authorize inside trading by its agents. By contrast, however, *Chiarella* focused the classic disclose or abstain rule on fraud perpetrated on the specific investors with whom the insiders trade.[96] Authorization of inside trading by the issuer's board of directors, or even a majority of the shareholders, does not constitute consent by the specific investors with whom the insider trades. Nothing in *O'Hagan* explicitly suggests an intent to undermine the *Chiarella* interpretation of the traditional disclose or abstain rule. To the contrary, Justice Ginsburg expressly stated that the two theories are "complementary."[97] Because the disclose or abstain thus remains conceptually

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[95] *Id.* at 436 (Easterbrook, J.) (citations omitted).

[96] Chiarella v. United States, 445 U.S. 222, 232 (1980).

[97] *O'Hagan*, 521 U.S. at 652.

distinct from the misappropriation theory, the authorized trading dictum can be plausibly limited to the latter context.

Irrespective of whether the foregoing prediction is ratified, the mere fact that the issue arose in the first instance is instructive. Did Justice Ginsburg intend to validate the property rights approach to insider trading? Did Justice Ginsburg intend to validate contractual waivers of Rule 10b-5 duties? I doubt it. She probably did not even realize that her dictum had implications going beyond the misappropriation context.[98]

Declining to ascribe intentionality to the portions of the majority opinion pointing towards a property rights basis for the prohibition is further justified by the fact that the opinion quickly shifted gears towards treating the problem as one sounding in traditional securities fraud: "Deception through nondisclosure is central to the theory of liability for which the government seeks recognition," and which the majority accepted.[99] Indeed, the incoherence of the majority opinion on policy issues is well-illustrated by its arguable revival of the long-discredited equal access theory of liability. In justifying her claim that the misappropriation theory was consistent with §10(b), for example, Justice Ginsburg opined that the theory advances "an animating purpose of the Exchange Act: to insure [sic] honest securities markets and thereby promote investor confidence."[100] She went on to claim that "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law,"[101] because those who trade with misappropriators suffer from an informational disadvantage "that cannot be overcome with research or skill."[102] The parallels to *Texas Gulf Sulphur* are obvious. If we want to protect investors from informational disadvantages that cannot be overcome by research or skill, moreover, the equal access test is far better suited to doing so than the *Chiarella*/*Dirks* framework.

Yet, predictably, the majority showed no greater fidelity to equality of access to information than it did to protection of property rights. Pre-*O'Hagan* it

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[98] For an argument that bounded rationality and institutional incentives leave the Supreme Court almost incapable of dealing with securities fraud cases, see Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 Emory L.J. 83 (2002).

[99] *O'Hagan*, 521 U.S. at 654.

[100] *Id.* at 658.

[101] *Id.*

[102] *Id.* at 658-59.

was widely assumed that the misappropriation theory would impose liability on those who steal nonpublic information (such as the sort of industrial espionage Charlie Sheen's character perpetrated in Oliver Stone's movie Wall Street). In *O'Hagan*, however, the majority made clear that disclosure to the source of the information is all that is required under Rule 10b-5. If a misappropriator brazenly discloses his trading plans to the source, and then trades (either with the source's approval or over its objection), Rule 10b-5 is not violated.

The brazen misappropriator dictum is inconsistent with both an investor protection rationale for the prohibition and the property rights justification. As to the former, investors who trade with a brazen misappropriator presumably will not feel any greater confidence in the integrity of the securities market if they later find out that the misappropriator had disclosed his intentions to the source of the information. As to the latter, requiring the prospective misappropriator to disclose his intentions before trading provides only weak protection of the source of the information's property rights therein. To be sure, in cases in which the disclosure obligation is satisfied, the difficult task of detecting improper trading is eliminated. As the majority pointed out, moreover, the source may have state law claims against the misappropriator. In some jurisdictions, however, it is far from clear whether inside trading by a fiduciary violates state law.[103] Even where state law proscribes such trading, moreover, the Supreme Court's approach means that in brazen misappropriator cases we lose the comparative advantage the SEC has in litigating insider trading cases and the benefit of the well-developed and relatively liberal remedy under Rule 10b-5.

In sum, the internal inconsistencies that plague the majority opinion preclude any reading of *O'Hagan* that ascribes rational intentionality thereto. The opinion fails to cohere as to either policy or doctrine. It forecloses neither the equal access nor the property rights policy rationale for the rule, while also failing to privilege either rationale. Just as a child might break his toy by attempting to force a square peg into a round hole, the Supreme Court made a hash of insider trading law (and Rule 10b-5 generally) by attempting to force insider trading into a paradigm—securities fraud—that does not fit.

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[103] *See* Bainbridge, *supra* note 4, at 1216-27 (discussing state law on insider trading by corporate counsel, officers, and directors).