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The Misappropriation Theory as a Permissible Basis of Section 10(b) Liability

United States v. O'Hagan

I. INTRODUCTION

Whether the misappropriation theory is a permissible basis for liability under section 10(b) of the Securities Exchange Act is an issue that has split the U.S. Courts of Appeals. The issue turns on the statutory interpretation of section 10(b) and Rule 10b-5, as well as policy considerations. The Supreme Court finally settled the issue in United States v. O'Hagan, when it reversed the Eighth Circuit and permitted the United States government to base section 10(b) liability on the misappropriation theory. The effect of the Court's decision is to make a person liable under section 10(b) if he received material and non-public information from someone to whom he owed a fiduciary duty, traded in securities for his personal profit based on such information, and did so without disclosing his trading activities to the fiduciary.

II. FACTS AND HOLDING

Following an investigation by the Securities and Exchange Commission (SEC), the United States indicted and subsequently convicted James Herman O'Hagan for fifty-seven counts of mail fraud, securities fraud, and money laundering. O'Hagan was a partner in the law firm of Dorsey & Whitney when Grand Met, a London-based company, hired Dorsey & Whitney to represent it in an attempt to acquire Pillsbury Company (Pillsbury). Before Grand Met could...
make a tender offer to Pillsbury, it had to sell a subsidiary company to raise the
capital to finance the purchase.9

During this several-month waiting period, O’Hagan bought 3000 call options10 for Pillsbury stock and bought approximately 5000 additional shares outright.11 After Grand Met publicly announced its tender offer to acquire Pillsbury, Pillsbury’s stock rose from $39 per share to nearly $60 per share.12 Soon after this price increase, O’Hagan exercised his options to buy Pillsbury stock at the previously set price, then immediately sold the stock along with the other 5000 shares he owned for a profit of over $4 million.13 The SEC soon started an investigation of O’Hagan, which resulted in the United States indicting O’Hagan for violating section 10(b) and Rule 10b-5 of the Securities Exchange Act.14 O’Hagan was convicted on all fifty-seven counts of mail fraud, securities fraud and money laundering, and he subsequently appealed the convictions to the Eighth Circuit Court of Appeals.15

O’Hagan argued that the liability theory under which he was convicted, the “misappropriation theory,” is an impermissible basis for conviction under section 10(b) of the Securities Exchange Act.16 The government argued that the misappropriation theory is a permissible basis for liability under section 10(b), so the convictions should be affirmed.17 The district court upheld the jury’s verdict convicting O’Hagan on all fifty-seven counts and sentenced him to forty-one months in prison.18

The Eighth Circuit Court of Appeals reversed O’Hagan’s convictions on all fifty-seven counts, holding that his convictions under section 10(b) of the Securities Exchange Act could not be based on the misappropriation theory.19 The court held that buying shares of Pillsbury’s stock based upon material non-public information that O’Hagan learned from Grand Met, his firm’s client, was

9. Id.

10. A call option gives the buyer of the option the right to purchase a specified number of shares of stock at a price set at the time the call option is sold. There is generally a deadline for purchasing the stock, after which the call option expires. Id. at 614 n.1.

Each call option O’Hagan bought gave him the right to purchase 100 shares of Pillsbury stock. Id. By the time Grand Met made Pillsbury a tender offer, O’Hagan had 2500 call options remaining, the other 500 had expired. Id. at 614 n.2.

11. Id. at 614.
12. Id.
13. Id.
15. O’Hagan, 92 F.3d at 614.
16. Id. at 615.
17. Id. at 617.
18. Id. at 614.
not sufficient to support such a conviction where he did not owe a fiduciary duty to Pillsbury's shareholders.\textsuperscript{20}

The Supreme Court of the United States granted certiorari to resolve the conflict among the circuits.\textsuperscript{21} The Court subsequently held that a person violates section 10(b) of the Securities and Exchange Act when he buys or sells securities for a personal profit based on non-public information misappropriated in breach of a fiduciary duty owed to the source of the information.\textsuperscript{22}

III. LEGAL BACKGROUND

\textbf{A. The Misappropriation Doctrine and Its Applicability to Section 10(b)}

Section 10(b) of the Securities Exchange Act of 1934 provides:

\begin{quote}
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—... (b) To use or employ, in connection with the purchase or sale of any security ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.\textsuperscript{23}
\end{quote}

Thus, the keys to section 10(b) liability are manipulation and deception.\textsuperscript{24}

\begin{flushright}
\textsuperscript{20} O'Hagan, 92 F.3d at 614. The court also held that the SEC exceeded its rule making authority in passing section 14(e) of the Securities Exchange Act, but that portion of the decision is beyond the scope of this Note. \textit{See infra} note 220.
\textsuperscript{22} 117 S. Ct. 2199 (1997), rev'd 92 F.3d 612 (8th Cir. 1996). The Court also held that the Securities and Exchange Commission did not exceed its rule-making authority when it promulgated Rule 14e-3(a) without requiring that the trading entail a breach of fiduciary duty. \textit{Id.} at 2215-17.
\textsuperscript{24} \textit{See} O'Hagan, 92 F.3d at 615. \textit{United States v. O'Hagan} deals only with deception, not manipulation. \textit{Id.} Section 10(b) manipulation is "'virtually a term of art when used in connection with securities markets'" referring to practices "'such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity.'" Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 476 (1977) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).
\end{flushright}
Acting pursuant to its authority granted by section 10(b), the Securities and Exchange Commission promulgated Rule 10b-5. Rule 10b-5 provides in relevant part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) [t]o employ any device, scheme, or artifice to defraud, [or] . . . (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 includes a prohibition of conduct constituting "fraud," while section 10(b) does not mention fraud, only manipulation or deception.

Through court decision, two theories of construing the scope of conduct prohibited by section 10(b) and Rule 10b-5 have developed. The classical theory prohibits a person from buying or selling securities on the basis of non-public, material information if that person is an insider of the corporation whose securities are traded. The classical theory does not reach "outsiders"—those individuals who do not owe a fiduciary obligation to the corporation whose shares are traded.

The second theory, the misappropriation theory, stems from the use of the word "fraud" in Rule 10b-5. This theory has been held to impose section 10(b) liability on an individual who "(1) misappropriates material non-public information (2) by breaching a duty arising out of a relationship of trust and confidence and (3) uses that information in a securities transaction, (4) regardless of whether he owed any duties to the shareholders of the traded stock." The misappropriation theory does not focus on whether the person trading the securities owes a fiduciary duty to the corporation whose stock is traded.

25. 15 U.S.C. § 78j(b) (1994) ("[I]n contravention of . . . regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.").
27. Id.
28. Id.
31. O'Hagan, 92 F.3d at 616 (citing Clark, 915 F.2d at 443).
33. Cherif, 933 F.2d at 409.
It focuses on whether the individual trading securities misappropriated the information, in other words, whether he or she breached a fiduciary duty to any lawful possessor of material non-public information.\textsuperscript{34} The requirement that the information be used "in connection with the purchase and sale of any security" is satisfied when the information is used in a subsequent securities transaction.\textsuperscript{35} Therefore, the misappropriation theory focuses on whether the securities trader "breached a fiduciary obligation to the party from whom the material non-public information was obtained, notwithstanding whether that party had any connection to, or even an interest in, the securities transaction . . . ."\textsuperscript{36}

**B. Relevant Supreme Court Cases**

The Supreme Court has spoken many times on the scope of conduct prohibited by section 10(b), but, prior to United States v. O'Hagan, it had never decided the issue of whether the misappropriation theory is a permissible basis for liability under that provision. One of the earlier Supreme Court cases dealing with the scope of conduct prohibited by section 10(b) is Superintendent of Insurance v. Bankers Life & Casualty Co.\textsuperscript{37} What has been termed the "touch" test arose from the Court's following language in this case: "[t]he crux of the present case is that [the victim] suffered an injury as a result of deceptive practices touching its sale of securities as an investor."\textsuperscript{38} In O'Hagan, the government relied on this language for the proposition that section 10(b) does not require a fiduciary obligation, so long as the deception " touches" the securities transaction.\textsuperscript{39} However, the Eighth Circuit disagreed with this interpretation.\textsuperscript{40} In the immediately preceding paragraph of its opinion, the Court read section 10(b) to mean that "Congress meant to bar deceptive devices and contrivances in the purchase or sale of securities."\textsuperscript{41}

\textsuperscript{34} Id.
\textsuperscript{35} Bryan, 58 F.3d at 944-45.
\textsuperscript{36} O'Hagan, 92 F.3d at 617 (citing Bryan, 58 F.2d at 944-45).
\textsuperscript{37} Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). In Bankers Life, the Court addressed whether there was a section 10(b) cause of action where: (1) a corporate investor is defrauded by its own corporate officer and his outside collaborators; (2) where the securities transaction was not conducted through an organized market; and (3) where the creditors of the corporate seller may be the ultimate victims. Id. at 6-9.
\textsuperscript{38} Id. at 12-13. The person who deceived the victim owed a fiduciary duty to the victim, and the victim of the fraud in this case was a seller of securities who was injured as an investor. Id.
\textsuperscript{39} See O'Hagan, 92 F.3d at 619.
\textsuperscript{40} Id.
\textsuperscript{41} Bankers Life, 404 U.S. at 12.
Five years later, in *Ernst & Ernst v. Hochfelder*, the Supreme Court concluded that a section 10(b) cause of action requires *scienter*—an intent to deceive, manipulate, or defraud. The Court stated that the language of the statute is the beginning of every analysis involving statutory construction. It also warned against construing the statutory language too broadly where doing so would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning."

Most importantly, the *Ernst* Court addressed the Securities and Exchange Commission's rule-making power: "The rule-making power granted to an administrative agency charged with the administration of a federal statute is not the power to make law," but the "power to adopt regulations to carry into effect the will of Congress as expressed by the statute." The Court made clear that the scope of Rule 10b-5 cannot exceed the power Congress granted the Securities and Exchange Commission under section 10(b).

In *Santa Fe Industries, Inc. v. Green*, the Supreme Court again addressed the scope of section 10(b) and Rule 10b-5. The Court considered whether section 10(b) liability reached a breach of fiduciary duty without any charge of misrepresentation or lack of disclosure. The Court relied heavily on its previous *Ernst* decision. It reiterated that in determining what constitutes fraud under Rule 10b-5, it must first look to the language of section 10(b), and that "[a]scertainment of congressional intent . . . must . . . rest primarily on the language of that section." The Court also reemphasized the *Ernst* Court's statement regarding the scope of the Securities and Exchange Commission's power to promulgate Rule 10b-5.

The *Santa Fe* Court found that the language of section 10(b) did not indicate that Congress intended to prohibit any conduct not amounting to

43. *Id.* at 193.
44. *Id.* at 197.
45. *Id.* at 199.
46. *Id.* at 213.
47. *Id.* at 214 (quoting *Dixon v. United States*, 381 U.S. 68, 74 (1965)).
48. *Id.*
50. *Id.* at 464. More specifically, it involved the reach of section 10(b) and Rule 10b-5 as they relate to a Delaware short-form merger transaction used by the majority shareholders of a corporation to eliminate the minority interest. *Id.* at 464-65. The Court held that a breach of fiduciary duty alone, without misrepresentation or nondisclosure, was not sufficient for section 10(b) liability. *Id.* at 462, 473.
51. *Id.* at 472.
52. *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976)).
53. *Id.* at 472-73 (citing *Ernst*, 425 U.S. at 212-14).
manipulation or deception. The Court also stated that it had not found any evidence from the legislative history to support a departure from the language of the statute. Therefore the Court stated that "[w]hen a statute speaks so specifically in terms of manipulation and deception, ... and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute." The Court concluded its opinion by noting that there "may well be a need for uniform federal fiduciary standards to govern [transactions] such as that challenged in this complaint. But those standards should not be supplied by judicial extension of section 10(b) and Rule 10b-5. . . ."

Although Chiarella v. United States presented the Supreme Court with the misappropriation theory, the Court refused to address it. This case dealt with a printer employee who printed tender offers to purchase corporations and other financial information. The employee used the information he ascertained from the printed documents and traded on this information, without first disclosing this knowledge to the sellers of the securities. The Court concluded that a person who fails to disclose material non-public information prior to the securities transaction has committed fraud, but only when he is under an obligation to disclose. The Court further explained that a duty to disclose arises only when a person has information that the other party to the securities transaction has a right to know because of a fiduciary duty or a relationship of trust and confidence between the two parties.

The Court reversed Chiarella's convictions because the lower court effectively instructed the jury that Chiarella had a duty to disclose the material non-public information to everyone. Chiarella was not an "insider" nor did he have a relationship of trust and confidence with the sellers; he had no prior dealings with them.

The Court found that the appellate court's ruling that Chiarella had a duty to disclose the material non-public information to everyone "rested solely on its belief that the federal securities laws have created a system providing equal access to information necessary for reasoned and intelligent investment decisions, and that use of this information without disclosure by anyone is fraudulent because it gives certain buyers or sellers an unfair advantage over

54. Santa Fe, 430 U.S. at 473.
55. Id.
56. Id. (quoting Ernst, 425 U.S. at 214).
57. Id. at 480.
59. Id. at 224.
60. Id. at 228.
61. Id. (citing RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1976)).
62. Id. at 231.
63. Id. at 232.
buyers or sellers who do not have this information. The Court found this reasoning defective because "not every instance of financial unfairness constitutes fraudulent activity under section 10(b)," and the "element required to make silence fraudulent, [a duty to disclose,] is absent in this case." The Court concluded that a duty to disclose under section 10(b) does not exist from the mere possession of material non-public information.

The government asked, in the alternative, for the Court to affirm the convictions based on the misappropriation theory, arguing that Chiarella "breached a duty to the acquiring corporation when he acted upon information that he obtained by virtue of his position as an employee of a printer employed by the corporation." The Court refused to consider whether the misappropriation theory had merit because the government had failed to submit it to the jury as a basis for the conviction.

In his concurring opinion, Justice Stevens stated that he thought the majority was correct in not addressing the misappropriation theory, but he thought that "[t]he respectable arguments could be made in support of either position." Justice Brennan's concurring opinion stated that he thought the misappropriation theory was a permissible basis for liability under section 10(b), but Justice Brennan agreed that the Court should not have addressed the issue since it was not presented to the jury. Chief Justice Burger's dissent, however, embraced the misappropriation theory and believed that it had been presented to the jury, so Chiarella's convictions should have been affirmed. Chief Justice Burger stated that a person may obtain an advantage in the securities market through his superior experience or foresight, but not through unlawful means. He "would read section 10(b) and Rule 10b-5 . . . to mean that a person who has misappropriated non-public information has an absolute duty to disclose that information or refrain from trading." Chief Justice Burger noted that the repeated use of the word "any" supports this interpretation, and that the history of the statute, that it "assure that dealing in securities is fair and without undue preferences or advantages among investors," also supports this theory.

64. *Id.* (quoting United States v. Chiarella, 588 F.2d 1358, 1365 (2d Cir. 1978)).
66. *Id.* at 235.
67. *Id.*
68. *Id.* at 236.
69. *Id.* at 238 (Stevens, J., concurring).
70. *Id.* at 238-39 (Brennan, J., concurring).
71. *Id.* at 240 (Burger, C.J., dissenting).
73. *Id.*
74. *Id.* at 241 (interpreting 15 U.S.C. § 78(j)(5) (1994)).
The Court reaffirmed its Chiarella holding in Dirks v. SEC. The decision outlined the requirements for tippee liability under section 10(b). It emphasized that the Chiarella Court found that there was "no general duty to disclose" and "a duty to disclose under § 10(b) does not arise from the mere possession of non-public market information." The Court stated that it was "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."79

The Dirks Court specifically rejected the "information theory." The information theory, based on the policy argument that the antifraud provisions require equal information among traders, states that all traders must disclose non-public information before trading. The Court stated that the information theory conflicted with the "principle set forth in Chiarella that only some persons, under some circumstances, will be barred from trading while in possession of material non-public information."82 Finally, the Dirks Court expressed concern that "[i]mposing a duty to disclose or abstain solely because a person knowingly receives material non-public information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market."83

75. 463 U.S. 646 (1982).
76. A "tippee" is a person to whom insiders of a corporation reveal non-public information about the corporation's stock. See BLACK'S LAW DICTIONARY 1484 (6th ed. 1990).
77. Dirks v. SEC, 463 U.S. 646, 659-60 (1983). The Court held that a tippee's "duty to disclose or abstain from trading is derivative from that of the insider's duty." Id. at 647. "[W]hen the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach," the tippee assumes a derivative fiduciary duty to the shareholders not to trade on the information. Id. at 660. However, the Court also held that in order to find that the insiders breached their fiduciary duty to the shareholders, they must have given the information to the tippee for the "improper purpose of exploiting the information for their personal gain." Id. at 659. It is this requirement that the insider have the purpose of personal gain that the dissent attacks as creating a "new, substantive limitation on the scope of the duty owed by insiders to shareholders," that is contrary to public policy and has a lack of support from existing law. Id. at 671 (Blackmun, J., dissenting).
78. Id. at 654 (citing Chiarella v. United States, 445 U.S. 222, 235 (1980)).
79. Id. (citing Chiarella, 445 U.S. at 232) (alteration in original).
80. Id. at 657.
81. Id.
82. Id.
83. Id. at 658 (explaining that analysts commonly seek out information from corporate officers and other insiders in order to form a basis for determining the worth
Carpenter v. United States\textsuperscript{84} involved an employee of a newspaper who provided information to outsiders.\textsuperscript{85} The outsiders would trade on the potential impact that a column of the newspaper would have on the market.\textsuperscript{86} The lower court held that the “deliberate breach of [the newspaper employee’s] duty of confidentiality [to the newspaper] and [subsequent] concealment of the scheme was a fraud and deceit on the [newspaper].”\textsuperscript{87} Even though the victim of the fraud and deceit, the newspaper, was not a buyer or seller of securities, or even a market participant, the Supreme Court considered fraud to be “in connection with” the sale or purchase of securities within the meaning of section 10(b) and Rule 10b-5.\textsuperscript{88} The lower court stated that the “scheme’s sole purpose was to buy and sell securities at a profit based on advance information of the column’s contents.”\textsuperscript{89} The lower court rejected the newspaper employee’s argument that section 10(b) liability cannot be imposed because the victim of the fraud had no connection to the sale or purchase of securities.\textsuperscript{90} Thus, the employee effectively was convicted under section 10(b) based on the misappropriation theory.

The Supreme Court in Carpenter provided no view as to the validity of the misappropriation theory as a basis for section 10(b) liability, except to express that “[t]he Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts.”\textsuperscript{91} An affirmance by an evenly divided court is “not entitled to precedential weight.”\textsuperscript{92}

Finally, in Central Bank v. First Interstate Bank,\textsuperscript{93} the Supreme Court decided the issue of whether section 10(b) liability extends to those who do not engage in the manipulative or deceptive act, but who aid and abet the violation.\textsuperscript{94} In its analysis, the Court reaffirmed the holdings of Ernst,\textsuperscript{95} Santa Fe,\textsuperscript{96} and

of the corporation’s stock).

\textsuperscript{84} 484 U.S. 19 (1987).

\textsuperscript{85} Id. at 22-23.

\textsuperscript{86} Id.

\textsuperscript{87} Id. at 24.

\textsuperscript{88} Carpenter, 484 U.S. at 24.

\textsuperscript{89} Id.

\textsuperscript{90} Id.

\textsuperscript{91} Id.


\textsuperscript{93} 511 U.S. 164 (1994). The Court held that section 10(b) does not reach those who only aid and abet a violation of this provision. Id. at 191. The dissent would allow liability to attach to those who aid and abet. Id. at 192-94 (Stevens, J., joined by Blackmun, J., Souter, J., and Ginsburg, J., dissenting).

\textsuperscript{94} Id. at 166-67.

\textsuperscript{95} Id. at 173-74. See supra notes 40-46 and accompanying text.

\textsuperscript{96} Central Bank, 511 U.S. at 174. See supra notes 47-54 and accompanying text.
Chiarella\textsuperscript{97} regarding the scope of conduct prohibited by section 10(b). The Court reiterated that in determining the scope of conduct prohibited by section 10(b), the text of the statute controls.\textsuperscript{98} The Court stated that it had "refused to allow [Rule] 10b-5 challenges to conduct not prohibited by the text of [section 10(b)]."\textsuperscript{99} The Court mentioned that in determining the scope of section 10(b), the question is not whether it is good policy to prohibit particular conduct, but whether the language of section 10(b) covers the conduct.\textsuperscript{100} "Policy considerations cannot override [the] interpretation of the text and structure of [section 10(b)], except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it."\textsuperscript{101}

To summarize, the Supreme Court has spoken often about the scope of conduct prohibited under section 10(b). It has made clear that the language of section 10(b) is controlling and that policy arguments cannot override the text of the statute.\textsuperscript{102} The Court, on one occasion, refused to address the misappropriation theory issue because it was not submitted to the jury.\textsuperscript{103} On another occasion, the Court was divided on the issue, so it affirmed the convictions based on the misappropriation theory, without providing any analysis of the issue.\textsuperscript{104} However, the Supreme Court did not express an opinion on the validity of the misappropriation theory as a basis for liability under section 10(b).

\textbf{C. Circuits That Adopted the Misappropriation Theory as a Basis for Section 10(b) Liability}

The Second Circuit was the first to adopt the misappropriation theory as a basis for liability under section 10(b). The appellate court affirmed a conviction under this theory in \textit{United States v. Chiarella},\textsuperscript{105} which the Supreme Court reversed.\textsuperscript{106}

\begin{itemize}
\item \textsuperscript{97} \textit{Central Bank}, 511 U.S. at 174. \textit{See supra} notes 55-68 and accompanying text.
\item \textsuperscript{98} \textit{Central Bank}, 511 U.S. at 173, 177.
\item \textsuperscript{99} \textit{Id.} at 1731.
\item \textsuperscript{100} \textit{Id.} at 177.
\item \textsuperscript{101} \textit{Id.} at 188. (citing Demarest v. Manspeaker, 498 U.S. 184, 191 (1991)).
\item \textsuperscript{102} \textit{Id.} at 173, 177.
\item \textsuperscript{103} Chiarella v. United States, 445 U.S. 222, 236 (1980).
\item \textsuperscript{104} Carpenter v. United States, 484 U.S. 19, 24 (1987).
\item \textsuperscript{105} United States v. Chiarella, 588 F.2d 1358 (2d Cir. 1978), rev'd, 445 U.S. 222 (1980).
\end{itemize}
Later, in United States v. Newman, the Second Circuit successfully embraced the misappropriation theory. In this case, employees of investment banking firms misappropriated confidential information about mergers and acquisitions that clients entrusted to the firm. These employees conveyed this information to Newman, a securities trader and manager of a brokerage firm, who purchased stocks in the companies that were takeover targets. After the firm’s client announced the merger or acquisition, Newman sold the stocks for a profit, which he shared with the employees of investment banking firms who originally gave him the information.

The Second Circuit found that the employees of the banking firms had breached the trust and confidence that the firms’ clients placed in them, which was sufficient to constitute fraud under section 10(b) and Rule 10b-5. In reaching this conclusion, the court acknowledged that it would start with the language of the statute. However, the court only discussed Rule 10b-5 in connection with the scope of conduct prohibited by the statute. Regarding the “in connection with the purchase or sale of any security” language, the court said that when the cause of action is criminal, “the court’s concern must be the scope of the Rule, not plaintiff’s standing to sue.” It stated that the “courts, not the Congress, have limited Rule 10b-5 suits for damages to the purchasers and sellers of securities,” so when the action brought is criminal, rather than a private cause of action for damages, there is no requirement that the fraud be upon the purchaser or seller of the securities.

The court indicated that it did not need to spend much time on whether there was fraud or deceit. In concluding that Newman’s conduct constituted fraud or deceit, the court relied upon Chief Justice Burger’s dissent in Chiarella. The court noted that Newman “misappropriated—stole to put it bluntly—valuable non-public information entrusted to him in the utmost confidence.”

108. Id. at 15.
109. Id.
110. Id.
111. Id. at 15-16.
113. Id. at 16-17.
114. Id. at 17.
115. Id.
116. Id.
117. Newman, 664, F.2d at 17.
118. Id. (quoting Chiarella v. United States, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting)).
banking firms "as surely as if they took their money." The Second Circuit also found that Newman had wronged the banking firms' clients who had entrusted their takeover plans with the firms. Lastly, the court supported its finding of fraud and deceit with cases which have held misappropriation of confidential non-public information unlawful in other areas of law.

The Second Circuit found that the fraud was "in connection with" the purchase or sale of the securities because Newman's sole purpose in receiving misappropriated information was to purchase stocks for financial gain. It also relied upon the "touch" test from Superintendent of Insurance v. Bankers Life & Casualty Co., where the court said the Supreme Court had construed the "in connection with" language flexibly to include practices touching the purchase or sale.

In Moss v. Morgan Stanley, Inc., the Second Circuit seemed to attack its own reasoning in Newman. Moss arose out of the same facts as Newman and was a private cause of action for damages by stockholders who had sold their stock to Newman. The court held that there was no basis for section 10(b) liability for damages, because Newman owed the stockholders no duty to disclose the non-public information which he possessed. Newman was neither an "insider" of the corporation whose stock they were trading, nor did Newman and the stockholders have a relationship of trust and confidence, one of which is required before a duty to disclose arises. The court contrasted its holding with Newman, where it held that the "transactions [by the employees of the banking firm] constituted a breach of their fiduciary duty of confidentiality and loyalty to their employers . . . and thereby provided the basis for criminal prosecution under [section 10(b) and Rule 10b-5]."

The Second Circuit later reaffirmed its support of the misappropriation theory as a basis for criminal liability under section 10(b) in SEC v. Materia. Under facts very similar to those in Chiarella, the court found that the

119. Id.
120. Id.
121. Id. at 18.
122. Id.
125. Id. at 16.
126. Id. at 8-9.
127. Id.
128. Id. at 11.
129. Id. at 13 (citing Newman, 664 F.2d 12 (1981)).
130. SEC v. Materia, 745 F.2d 197 (2d Cir. 1984).
131. See supra notes 55-68 and accompanying text.
employee of a printer had committed fraud against his employer under section 10(b).\textsuperscript{132} It explained \textit{Moss} as having distinguished between civil and criminal liability under section 10(b), and stated that \textit{Newman}’s misappropriation theory applied only to criminal prosecutions.\textsuperscript{133} The court reiterated that it was the scope of the rule, not the direction in which a duty must be owed, that it was concerned with.\textsuperscript{134}

Adding to the “in connection with” analysis of \textit{Newman}, the court stated that “[w]hatever limitations have been read into the ‘in connection with’ language in the past, . . . it is clear that the requirement is satisfied by the self-evident nexus presented in this case.”\textsuperscript{135} The limitation the court referred to was from a Supreme Court case which held that in private civil actions under section 10(b), the “in connection with” language limits standing to a buyer or seller of securities.\textsuperscript{136}

The Third Circuit followed the Second Circuit in \textit{Rothberg v. Rosenbloom}.\textsuperscript{137} The Third Circuit devoted only one paragraph to the misappropriation theory issue, relying heavily on distinguishing the facts of \textit{Chiarella}.\textsuperscript{138} The court found that \textit{Chiarella} dealt with a person who did not owe a fiduciary duty to either the acquiring corporation or the corporation to be acquired, since he was an employee of a printer of financial merger information.\textsuperscript{139} The Third Circuit contrasted that situation with Rothberg, a tippee of an insider, who owed a fiduciary duty to the acquiring corporation.\textsuperscript{140} The court stated that an “insider on either side of a proposed transaction violates the insider trading rule when he uses insider information in violation of a fiduciary duty owed to the corporation to which he owes a duty of confidentiality.”\textsuperscript{141} The court also made a general reference to \textit{Newman} in support of its adoption of the misappropriation theory.\textsuperscript{142}

The Ninth Circuit also adopted the misappropriation theory as a basis for liability under section 10(b) in \textit{SEC v. Clark}.\textsuperscript{143} The court reviewed the development of the misappropriation theory through the Second and Third Circuits and noted that the “careful thought” that went into the analyses and the

\textsuperscript{132} \textit{Materia}, 745 F.2d at 202.

\textsuperscript{133} \textit{Id}.

\textsuperscript{134} \textit{Id}.

\textsuperscript{135} \textit{Id} at 203.

\textsuperscript{136} \textit{Id} (citing Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)).

\textsuperscript{137} \textit{Rothberg} v. \textit{Rosenbloom}, 771 F.2d 818 (3d Cir. 1985).

\textsuperscript{138} \textit{Id} at 822.

\textsuperscript{139} \textit{Id}.

\textsuperscript{140} \textit{Id}. See \textit{supra} note 70 (defining “tippee”).

\textsuperscript{141} \textit{Rothberg}, 771 F.2d at 822.

\textsuperscript{142} \textit{Id}.

\textsuperscript{143} \textit{SEC v. Clark}, 915 F.2d 439 (9th Cir. 1990).
"consistency with which it has been applied [was] impressive."144 The court stated that the words "fraud" and "deceit" are vague and provide a "linguistic frame within which a large number of practices may fit."145 In concluding that the misappropriation theory fits within the concept of fraud, the court relied on the meaning of fraud in other federal statutes.146 The court acknowledged that the fraud must be "in connection with the purchase or sale of any security."147 It relied on the "touch" test from Bankers Life to say that this issue turns on whether there is "some nexus between... [the misappropriated information] and any securities transaction."148 After a lengthy look at the legislative history of the statute, the court concluded that the statute's history was consistent with allowing the misappropriation theory as a basis for criminal liability under section 10(b).149

Most recently, the Seventh Circuit, in SEC v. Cherif,150 joined the Second, Third, and Ninth Circuits in adopting the misappropriation theory as a permissible basis of section 10(b) liability.151 The court summarized the support the misappropriation theory had received from the Second, Third, and Ninth Circuits, and chose to join them in adopting it.152 In a footnote, the court explained that "the more precise issues of statutory construction and legislative history have been treated exhaustively elsewhere," so it would not revisit them.153 It supported this decision by stating that the vague word "fraud" can easily encompass the misappropriation theory, and that adopting this theory "effectuates the broad purposes behind the securities laws."154

144. Id. at 448.
145. Id.
146. Id. at 448-49.
147. Id. at 449.
148. Id. (emphasis added).
149. Id. at 449-53.
150. SEC v. Cherif, 933 F.2d 403 (7th Cir. 1991). The Seventh Circuit later affirmed its position in SEC v. Maio, 51 F.3d 623 (7th Cir. 1995).
151. The court also had to determine whether Cherif owed a fiduciary duty to a former employer, because in civil actions, a person must have breached a fiduciary duty to a lawful possessor of non-public information in order for the misappropriation theory to be a basis of liability. Cherif, 933 F.2d at 411. For the court's analysis of this issue, see id. at 411-12.
152. Id. at 409-10.
153. Id. at 410 n.5.
154. Id.
D. Circuits That Rejected the Misappropriation Theory as a Basis for Section 10(b) Liability

In United States v. Bryan, the Fourth Circuit became the first circuit to reject the misappropriation theory as a basis of criminal liability under section 10(b). The court found the misappropriation theory to be "irreconcilable" with recent Supreme Court decisions. The court pointed out that the Supreme Court had "repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of [section 10(b)] will reasonably bear." The court stated that manipulation and deception are the "touchstones of section 10(b) liability." The court noted that the Supreme Court in Santa Fe defined section 10(b) "deception" as the "making of a material misrepresentation or the nondisclosure of material information in violation of a duty to disclose." The Supreme Court specifically rejected the Second Circuit's interpretation of section 10(b) that did not require a misrepresentation or a nondisclosure. Furthermore, the court stated that the Supreme Court in Dirks reemphasized that not all breaches of fiduciary duties are violations of section 10(b), because there must also be manipulation or deception.

The Fourth Circuit stated that the Supreme Court "has equally clearly instructed" that section 10(b) is "primarily if not exclusively concerned with the deception of purchasers and sellers of securities, but at most extends to purchasers and sellers, other investors, and persons with a similar stake in an actual or proposed securities transaction." "It is only the breach of a duty to these persons that can give rise to a criminal conviction under [section 10(b)], if the statutory requirement that the fraud be in connection with the purchase or sale of securities is not to be rendered meaningless.”

156. Id. at 944.
157. Id.
158. Id. at 945 (citing Central Bank v. First Interstate Bank, 511 U.S. 164, 173 (1994) (the text of section 10(b) is controlling with respect to the scope of conduct prohibited); Chiarella v. United States, 445 U.S. 222, 234 (1980) (section 10(b) cannot be read more broadly than the language of the provision permits)).
159. Id.
160. Id. at 946. See Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 470 (1977). See also Central Bank, 511 U.S. at 174 (reaffirming the requirement of either a misrepresentation or a nondisclosure).
162. Id. (citing Dirks v. SEC, 463 U.S. 646, 654 (1982)).
163. Id.
164. Bryan, 58 F.3d at 946.
In concluding that the misappropriation theory is not a permissible basis for section 10(b) criminal liability, the court addressed some policy concerns. The court discussed how the misappropriation theory creates uncertainty and unpredictability in the securities laws. As an example, it pointed out that the Second Circuit, which was the first to adopt the misappropriation theory, has “repeatedly grappled with its own misappropriation theory.” It stated that section 10(b) is “not concerned with the general fairness of securities transactions themselves, so long as there is no evidence of deception.” The court did not believe that rejecting the misappropriation theory would hinder federal efforts to combat securities fraud. Lastly, the court explained that its own “perceptions of what is wise or fair are ultimately of no relevance,” and that the court is “bound by the actual prohibitions enacted by Congress.

Following the Fourth Circuit’s decision in Bryan, the Eighth Circuit rejected the misappropriation theory as a basis for section 10(b) liability in United States v. O’Hagan. In rejecting this theory, the Eighth Circuit relied heavily on the Fourth Circuit’s analysis in Bryan. The court found unpersuasive the decisions of those circuits that had adopted the misappropriation theory as a basis for section 10(b) liability.

165. Id. at 952-53.
166. Id. at 952 (giving examples of the difficulties courts have grappled with in their efforts to determine which relationships of trust and confidence give rise to section 10(b) liability).
167. Id. at 951. See id. at 954-59 (analyzing the Second Circuit cases Newman, Moss, Matera, and Chestman). See also id. at 957-58 (other circuits adopting the misappropriation theory by referring to Newman, without conducting their own analysis, or without discussing Santa Fe).
168. Bryan, 58 F.3d at 952.
169. Id. at 953 (“Many of the people who would fall within the ambit of the misappropriation theory... already owe a duty to purchasers and sellers of securities to disclose or abstain from trading, duties recognized by the Supreme Court.... The Second Circuit has acknowledged as much.”) (citing Chestman, 947 F.2d at 566). Most conduct will fall under other federal statutes, such as the mail and wire fraud statutes. Id.
170. Bryan, 58 F.3d at 959.
172. Id. at 620; see Bryan, 58 F.3d at 933.
173. O’Hagan, 92 F.3d at 620. The Eighth Circuit found that the Second, Third, Seventh, and Ninth Circuits adopted the misappropriation theory without conducting either a thorough analysis of the text of section 10(b) or the Supreme Court decisions regarding section 10(b). Id. at 621. The Second Circuit adopted the misappropriation theory without referring to the language of section 10(b), without citing Santa Fe, and with only slight mention of the Chiarella majority opinion. Id. (citing Newman, 664 F.2d 12, 16-19 (2d Cir. 1981)). The Second Circuit instead relied heavily on the language of
The court’s analysis primarily focused on the language of the statute because the text of the statute was determinative when construing the scope of conduct prohibited under section 10(b). The conduct prohibited was limited to conduct constituting “deception... in connection with the purchase or sale of any security,” since Rule 10b-5’s prohibition of “fraud” could not be construed more broadly than “deception” under section 10(b).

The Eighth Circuit reasoned that the misappropriation theory did not require deception, even

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Chief Justice Burger’s dissent in Chiarella. Id.

The other circuits who had recognized the misappropriation theory either relied heavily on Newman or “utilized interpretational methods which conflict with the Supreme Court’s teachings on interpreting the scope of conduct encompassed by § 10(b).” O’Hagan, 92 F.3d at 621. See Rothberg v. Rosenblum, 771 F.2d 818, 822 (3d Cir. 1983) (relying solely on Newman); SEC v. Cherif, 933 F.2d 403, 410 n.5 (7th Cir. 1991) (relying on Newman and stating that the interpretation of the text of section 10(b) had already been “exhaustively” covered); SEC v. Clark, 915 F.2d 439, 443-53 (9th Cir. 1990) (relying in part on Newman and also utilizing the meaning of fraud in other contexts).

The O’Hagan court concluded that the circuits that recognize the misappropriation theory have appeared to validate it based upon the policy that it is unfair to allow a person to trade securities based upon information that is not available to other traders. O’Hagan, 92 F.3d at 620. See United States v. Carpenter, 791 F.2d 1024, 1029 (1986) (misappropriation theory permissible to give “legal effect to the commonsensical view that trading on the basis of improperly obtained information is fundamentally unfair...”). The Carpenter court agreed with the Fourth Circuit in its finding that the circuits which have recognized the misappropriation theory have given “insufficient weight to the text of § 10(b) and improperly construed the Supreme Court’s pronouncements on the reach of that provision.” O’Hagan, 92 F.3d at 621-22.


175. United States v. O’Hagan, 92 F.3d 612, 615 (8th Cir. 1996), cert. granted, 117 S. Ct 759, rev’d, 177 S. Ct. 2199 (1997); 15 U.S.C. § 78j(b) (1994). See 17 C.F.R. § 240.10b-5 (1997) (“To employ any device, scheme, or artifice to defraud, [or]... [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon a person, in connection with the purchase or sale of any security.”). See also Central Bank v. First Interstate Bank, 511 U.S. at 173 (1994) (“We have refused to allow 10b-5 challenges to conduct not prohibited by the text of the statute.”); Santa Fe Indus. v. Green, 430 U.S. 462, 472 (1977) (“[I]n deciding whether [challenged conduct constitutes] ‘fraud’ under Rule 10b-5, ‘we turn first to the language of § 10(b).’”) (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976)); United States v. Bryan, 58 F.3d 933, 945 (4th Cir. 1995) (“For at least two decades, . . . the Supreme Court has repeatedly warned against expanding the concept of fraud in the securities context beyond what the words of the Act will reasonably bear.”).
though the text of section 10(b) requires it for criminal liability.\textsuperscript{176} Even if the misappropriation theory did require deception, the requirement that the deception be "in connection with the purchase or sale of any security" negated it.\textsuperscript{177}

The Eighth Circuit looked to the Supreme Court for the definition of deception.\textsuperscript{178} The court stated that the Supreme Court "has repeatedly held that the deception prohibited under section 10(b) consists of the making of a material misrepresentation or the nondisclosure of material information, in violation of a duty to disclose."\textsuperscript{179} The Supreme Court had "left no doubt that section 10(b) deception cannot be premised on the mere breach of a fiduciary duty, without an accompanying misrepresentation or lack of disclosure."\textsuperscript{180} Thus, the Eighth Circuit rejected the misappropriation theory in part because, by the theory's definition, it required neither a material misrepresentation nor a nondisclosure.\textsuperscript{181}

The Eighth Circuit also rejected the misappropriation theory because it "permits liability for a breach of duty owed to individuals who are unconnected to and perhaps uninterested in a securities transaction, thus rendering meaningless the 'in connection with . . .' statutory language."\textsuperscript{182} The court reasoned that the Supreme Court's decisions in \textit{Chiarella},\textsuperscript{183} \textit{Dirks},\textsuperscript{184} and

\textsuperscript{176} O'Hagan, 92 F.3d at 617.
\textsuperscript{177} Id.
\textsuperscript{178} Id.
\textsuperscript{179} Id. See \textit{Central Bank}, 511 U.S. at 177 ("As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."); Santa Fe Indus. Inc. v. Green, 430 U.S. 462, 470-76 (explicitly rejecting a lower court's reading of section 10(b) which required no misrepresentation or nondisclosure).
\textsuperscript{180} O'Hagan, 92 F.3d at 618. See \textit{Central Bank}, 511 U.S. at 174 (quoting \textit{Santa Fe}, 430 U.S. at 470) ("deception" under section 10(b) does not encompass "breaches of fiduciary duty . . . without any charge of misrepresentation or lack of disclosure."); \textit{Santa Fe}, 430 U.S. at 472 (to interpret "fraud under Rule 10b-5 to extend to all breaches of fiduciary duty that are linked to a securities transaction would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning"); \textit{Dirks} v. SEC, 463 U.S. 646, 654 (1982) ("Not all breaches of fiduciary duty in connection with a securities transaction . . . come within the ambit of Rule 10b-5. There must also be manipulation or deception.").
\textsuperscript{181} O'Hagan, 92 F.3d at 618.
\textsuperscript{182} Id.
\textsuperscript{183} \textit{Chiarella}, 445 U.S. at 228-32 (holding that Rule 10b-5 fraud is committed by failing to disclose material non-public information in violation of a duty to disclose, which arises only "from a relationship of trust and confidence between the parties to a transaction," and that liability can only be founded on the breach of a fiduciary obligation by a "person in whom the sellers had placed their trust and confidence"). See supra notes 55-68 and accompanying text.
\textsuperscript{184} \textit{Dirks}, 463 U.S. at 654 (quoting \textit{Chiarella}, 445 U.S. at 232) (reaffirming \textit{Chiarella}'s holding that "there can be no duty to disclose where the person who has
Central Bank,185 "revealed that only a breach of a duty to parties to the securities transaction or, at the most, to other market participants such as investors, will be sufficient to give rise to § 10(b) liability."186

The government petitioned for certiorari to the Supreme Court of the United States, and the Supreme Court granted certiorari to resolve the conflict among the circuits.187

IV. INSTANT DECISION

A. Justice Ginsburg's Opinion for the Majority

The Supreme Court began with an analysis of the language of section 10(b).188 The Court reiterated that section 10(b) prohibits: "(1) using any deceptive device (2) in connection with the purchase or sale of securities, in contravention of rules prescribed by the Commission."189 The Court stated that the "in connection with the purchase or sale of securities" language did not limit traded 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.'). See supra notes 69-76 and accompanying text.

185. Central Bank, 511 U.S. at 171-73 (focusing section 10(b) liability on purchasers and sellers of securities). See supra notes 85-93 and accompanying text.

186. O'Hagan, 92 F.3d at 618. The court stated that the Supreme Court has relied on the policy of the Act, "to protect investors from false and misleading practices that might injure them," to support this limitation. Id. at 619 (quoting Central Bank, 114 S.Ct. at 1446).

The government argued that the "in connection with" requirement was met whenever a fraud "touched" the purchase or sale of a security, so that the fraud need not be upon a person interested in a securities transaction. Id. The court rejected the government's interpretation of Bankers Life & Casualty as overly broad and inconsistent with the Supreme Court's decision which stated that Congress meant for section 10(b) "to bar deceptive devices and contrivances in the purchase or sale of securities." Id. (quoting Superintendent of Ins. v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971)); see supra notes 35-37 and accompanying text. The court also found important that the victim of the fraud in the Bankers Life & Casualty case was a seller of securities who was "injured as an investor." Id. (quoting Bankers Life, 404 U.S. at 10). Finally, the O'Hagan court concluded that if the Supreme Court intended the interpretation that the government contended, then the defendants in subsequent Supreme Court cases would not have escaped liability, because each engaged in conduct that "touched" the securities transaction. Id. (referring to Chiarella, Dirks, and Central Bank).


188. 117 S. Ct. 2199, 2206-08 (1997). The Court reiterated that liability under Rule 10b-5 could not extend beyond that conduct prohibited by section 10(b). Id.

189. Id.
the application of the statute to only deception of a seller or purchaser of securities.\textsuperscript{190}

The Court explained that the classical and misappropriation theories are complimentary in that they both address efforts "to capitalize on nonpublic information through the purchase or sale of securities."\textsuperscript{191} The classical theory targets trading of securities where there is a breach of duty to shareholders of a corporation, whereas the misappropriation theory targets a breach of duty to the source of the nonpublic information.\textsuperscript{192}

The Court found O'Hagan's conduct to be deceptive.\textsuperscript{193} O'Hagan owed a duty to both his law firm and his firm's client to keep the information confidential and to not use it for his personal profit.\textsuperscript{194} When O'Hagan traded based on the non-public information without disclosing his intentions to either his firm or his firm's client, his conduct amounted to deception.\textsuperscript{195} Had O'Hagan disclosed all pertinent facts to both his law firm and his firm's client, then he could not have been liable under section 10(b) because there would not have been the required deception through nondisclosure.\textsuperscript{196}

The Court also found O'Hagan's deception to be "in connection with the purchase or sale of any security," since the breach of duty and the securities transaction coincided.\textsuperscript{197} O'Hagan's fraud was consummated when he used the information to trade in securities without disclosure to the source of the information, not when he received the information.\textsuperscript{198} The Court suggested that if O'Hagan had not traded on the information, but instead had put it to another use, then he would not have been liable under section 10(b).\textsuperscript{199}

The Court clarified the limits of the misappropriation theory: if a person used money which he received through embezzlement or fraud to purchase securities, then the misappropriation theory would not apply.\textsuperscript{200} The Court reasoned that, because such ill-gotten money can be used for many purposes other than buying securities, the deception in such a case would not be

\textsuperscript{190} Id.
\textsuperscript{191} Id.
\textsuperscript{192} Id.
\textsuperscript{193} O'Hagan, 117 S. Ct. at 2208.
\textsuperscript{194} Id.
\textsuperscript{195} Id.
\textsuperscript{196} Id. at 2209. See Santa Fe Indus. Inc., v. Green 430 U.S. 462, 474-76 (1977) (person charged with violating section 10(b) had disclosed all pertinent facts to the person to whom he owed a duty of confidentiality, so there was no deception through nondisclosure which supported section 10(b) liability).
\textsuperscript{198} O'Hagan, 117 S. Ct. at 2209.
\textsuperscript{199} Id.
\textsuperscript{200} Id.
sufficiently connected to the securities transaction. The Court distinguished, however, the fraudulent use of non-public information, as opposed to money. For the Court, there was no question that the fraudulent use of confidential information, such as the information in this case, falls within section 10(b)'s prohibition where such information "ordinarily" is used only to trade in securities.

The Court also noted that strong policy considerations supported its decision. According to the Court, the purpose of the Securities and Exchange Act is "to insure honest securities markets and thereby promote investor confidence." The Court expressed concern that people would likely hesitate to invest in a market "where trading based on misappropriated nonpublic information is unchecked by law." The Court summarized that "considering the inhibiting impact on market participation of trading on misappropriated information, and the congressional purposes underlying § 10(b)," it made sense to permit the misappropriation theory as a basis for section 10(b) liability, and that the language of section 10(b) did not require otherwise.

The Court spent considerable time addressing the Eighth Circuit's reasons for rejecting the misappropriation theory. First, the Court reiterated that the Eighth Circuit's finding that the misappropriation theory required neither misrepresentation nor disclosure was incorrect. O'Hagan's failure to disclose the pertinent facts to his law firm and his firm's client pursuant to his duty to do so was sufficient deception to support section 10(b) liability.

Second, the Court addressed the Eighth Circuit's contention that the misappropriation theory did not satisfy the "in connection with the purchase or sale of any security" requirement for section 10(b) liability. The Court noted that the Eighth Circuit relied on three prior Supreme Court decisions in

[References]
201. Id.
202. Id.
203. The Court explained that the government made an "overstatement" when it argued that the kind of confidential information in this case derived its value "only from its utility in securities trading." Id. at 2210. The dissent struggled with the majority's explanation and modification of the government's theory. See supra Part IV.B.
204. O'Hagan, 117 S. Ct. at 2210.
205. Id.
206. Id.
207. Id.
208. Id. at 2210-11.
209. Id. at 2211-14.
211. Id.
212. Id.
concluding that only a breach of duty to parties to the securities transaction, or at least market investors, supplied the requisite connection. The Supreme Court disagreed with the Eighth Circuit's reading of its precedent. It reviewed the three cases relied upon by the Eighth Circuit, and explained why they did not support the rejection of the misappropriation theory. The Court stated that Chiarella stands for the proposition that no general obligation exists between parties to a securities transaction to disclose material, non-public information. Such a duty arises only between two parties having a relationship of trust and confidence. The Court explained that the Eighth Circuit took these statements to imply that a duty to disclose could arise only between parties to the securities transaction. The Eighth Circuit, however, did not take into account that the Supreme Court had refused to address whether the misappropriation theory was a permissible basis for liability. The Supreme Court had not rejected the theory in Chiarella, but simply had not addressed the issue.

Next, the Court explained that the Eighth Circuit misinterpreted its decision in Dirks primarily by relying on the language cited from Chiarella. The Court stated that Dirks held that there was no general duty for a tippee to refrain from disclosing non-public information to people likely to trade on the basis of such information. The corporate insiders had given the tippee non-public information for the purpose of revealing fraud, and they had no expectation that the tippee would keep the information confidential. Therefore, because the corporate insiders did not misappropriate the information, the tippee could not have done so either. The Eighth Circuit incorrectly interpreted this to mean that only a failure to disclose non-public information to a party of the transaction, where there was a duty to do so, could result in section 10(b) liability.

Lastly, the Court explained the Eighth Circuit's misinterpretation of Central Bank. The Central Bank Court held that a private plaintiff cannot "maintain

213. Id.
214. Id.
215. Id. at 2211-14.
219. Id.
220. Id.
221. Id. at 2212 n.10. See Dirks v. SEC, 463 U.S. 646 (1983).
223. Id.
224. Id.
225. Id.
an aiding and abetting suit under § 10(b).\footnote{O'Hagan, 117 S. Ct. at 2213. See Central Bank, 511 U.S. at 191.} The Court cautioned that a secondary actor, such as an attorney or an accountant, could be held primarily liable under section 10(b) if he used a deceptive device upon which a buyer or seller of securities relied.\footnote{Id.} The Eighth Circuit misread that statement to imply that section 10(b) covered only deceptive misstatements to market participants.\footnote{Id. at 2213-14.} The Court meant only to clarify that while a secondary actor could not be held secondarily liable for aiding and abetting, he could still be held primarily liable.\footnote{Id. at 2220. (Scalia, J., concurring in part and dissenting in part).}

The Court also explained that Central Bank dealt only with private civil litigation, and that there had been a longstanding distinction between criminal liability and civil liability with regard to section 10(b).\footnote{Id. at 2220-26. (Thomas, J., with whom Rehnquist, C.J., joined, concurring in part and dissenting in part).} In conclusion, the Court accepted the application of the misappropriation theory, noting that the theory is consistent with the Court’s precedent and with the language of the statute.\footnote{Id. at 2221.}

\section*{B. Dissenting Opinions of Justices Scalia and Thomas}

Justice Scalia disagreed with the Court’s decision to accept the misappropriation theory as a basis for section 10(b) liability.\footnote{Id. at 2221-22.} Because, according to Justice Scalia, the language of section 10(b) is ambiguous with regard to whether or not the deception must be of a party to a securities transaction, Justice Scalia would invoke the rule of lenity.\footnote{O'Hagan, 117 S. Ct. at 2220. (Scalia, J., concurring in part and dissenting in part).} Thus, the misappropriation theory would not be a permissible basis for liability since the statutory language does not clearly indicate such a result.\footnote{Id. at 2221.}

Justice Thomas wrote a separate dissenting opinion, in which Chief Justice Rehnquist joined.\footnote{Id. at 2220-26. (Thomas, J., with whom Rehnquist, C.J., joined, concurring in part and dissenting in part).} Justice Thomas disagreed with the majority’s determination of the circumstances in which a deceptive device is “in connection with” a securities transaction.\footnote{Id. at 2221.} He found the majority’s distinction between embezzlement of funds and misappropriation of information incoherent, because information, like money, could be used for many purposes.\footnote{Id. at 2221-22.} Justice Thomas
also disagreed with the majority’s substitution of the word “ordinarily” for the government’s choice of the word “only” regarding the propensity of information to be used in a securities transaction.\textsuperscript{239} He expressed concern that the Court, by changing the wording, applied a new theory that the government did not consider or ask for.\textsuperscript{240}

Finally, Justice Thomas dissented from the majority’s reliance on the “purpose” of the statute.\textsuperscript{241} He stated that “regardless of the overarching purpose of the securities laws, it is not illegal to run afoul of the ‘purpose’ of a statute, only its letter.”\textsuperscript{242} Furthermore, Justice Thomas noted that the market is hurt equally whether or not a party to a securities transaction discloses his trading to the source of his information.\textsuperscript{243} The other party to the transaction is still on an unequal playing field, because the other party does not have the same non-public information.\textsuperscript{244}

V. COMMENT

The Supreme Court’s opinion in \textit{O’Hagan} clarified an issue that had been the subject of great differences.\textsuperscript{245} Even those who may disagree with the Court’s holding can appreciate the Court’s thorough analysis of the issue. The Court discussed both the statutory language of section 10(b) and previous Supreme Court decisions interpreting that section, and gave valuable insight into how the Court reads its prior decisions.\textsuperscript{246} The Eighth Circuit’s careful interpretation of the Supreme Court’s teachings seemed well-reasoned.\textsuperscript{247} Perhaps for that reason, the Supreme Court felt it necessary to discuss the primary cases in some detail and explain the Eighth Circuit’s misinterpretation of those holdings.\textsuperscript{248}

Despite the Supreme Court’s detailed analysis, the Court’s explanation of the manner in which O’Hagan’s deception was “in connection with” the sale of

\begin{itemize}
  \item \textsuperscript{239} \textit{Id.} at 2223-25.
  \item \textsuperscript{240} \textit{O’Hagan}, 117 S. Ct. at 2223-25.
  \item \textsuperscript{241} \textit{Id.} at 2225-26.
  \item \textsuperscript{242} \textit{Id.} at 2225.
  \item \textsuperscript{243} \textit{Id.} at 2225-26.
  \item \textsuperscript{244} \textit{Id.}
  \item \textsuperscript{245} \textit{See supra} Part III.
  \item \textsuperscript{246} \textit{See United States v. O’Hagan}, 117 S. Ct. 2199, 2206-13 (1997).
  \item \textsuperscript{247} \textit{United States v. O’Hagan}, 92 F.3d 612, 617-22 (8th Cir. 1996), \textit{rev’d}, 117 S. Ct. 2199 (1997). The court acknowledged the strong policy considerations, but did not decide the case based on those considerations. \textit{Id.} at 628. While the court adopted the Fourth Circuit’s analysis from \textit{Bryan}, it did not do so blindly. \textit{Id.} at 620.
  \item \textsuperscript{248} \textit{O’Hagan}, 117 S. Ct. at 2221-23.
\end{itemize}
the securities may cause some confusion in the future. 249 Future parties may find the Court’s distinction between stealing money to buy securities and using non-
public information to buy securities without disclosing the facts to the source of the information difficult to apply to other situations. 250 Justice Thomas’ dissent certainly cast doubt on the strength of the majority’s reasoning with regard to that distinction 251—a distinction crucial to the Court’s approval of the misappropriation theory as a basis for section 10(b) liability. 252

Meanwhile, Justice Scalia’s reliance on the rule of lenity as the basis for his rejection of the misappropriation theory appears to be a novel concept discussed by neither the Eighth Circuit nor the Supreme Court majority. 253 Essentially, Justice Scalia revealed the unfairness of holding O’Hagan liable for violating a criminal statute when it was unclear whether Congress intended that his conduct be a basis for liability. Considering the disagreement among the circuits, the Supreme Court at least should have acknowledged Justice Scalia’s application of the rule of lenity.

Conspicuously, the Court never stated that the statutory language expressed an intention by Congress to incorporate the misappropriation theory. The Court noted only that nothing in the language of section 10(b) precluded the application of the misappropriation theory. 254 In fact, the Court discussed its prior line of cases to demonstrate that applying the misappropriation theory would not be inconsistent with its precedent; not that its precedent required or even strongly suggested such an application. 255

249. *Id.* at 2209-11.
250. *Id.*
251. *Id.* at 2221-25. (Thomas, J., with whom Rehnquist, C.J., joins, concurring in part and dissenting in part).
252. *Id.* at 2206-07.
253. *Id.* at 2220. (Scalia, J., concurring in part and dissenting in part).
255. *Id.* at 2211-14.
The Court’s decision to permit liability based upon the misappropriation theory seems primarily to be driven by strong policy considerations. After a thorough analysis of the statute and prior Supreme Court cases, the Court summarized the basis for its holding:

In sum, considering the inhibiting impact on misappropriated information, and the congressional purposes underlying § 10(b), it makes scant sense to hold a lawyer like O’Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder. The text of the statute requires no such result.256

The Supreme Court seems to have based its decision on its sense of the conduct the statute should prohibit, rather than the conduct Congress, by its plain language, clearly prohibited. As Justice Thomas noted, holding O’Hagan liable under section 10(b) on the present facts, but not holding him liable should he disclose his trading to his law firm and the firm’s client, makes little sense. The impact on the market is the same.257 The Court, however, dismissed such a concern when it was raised by Justice Thomas’ dissent, reasoning that a partial solution is just as permissible as a complete solution.258

The Court could have rejected the misappropriation theory without condoning O’Hagan’s conduct.259 Indeed, the Eighth Circuit felt strongly that O’Hagan’s conduct was “unethical and immoral and [should be] condemned.”260 Nevertheless, as the Eighth Circuit noted, not every unethical or immoral act is illegal.261 And as Justice Thomas stated, “it is not illegal to run afoul of the ‘purpose’ of a statute, only its letter.”262 Aside from section 10(b) liability, there are other remedies available to deter such conduct.263 For example, the Court could have left the issue to Congress to clarify its intentions by amending the statute.

257. See id. at 2225-26 (Thomas, J., concurring in part and dissenting in part).
258. Id. at 2211, n.9.
260. Id.
261. See O’Hagan, 92 F.3d at 628 (“[I]t is a fundamental principle of the criminal law that not every ethical or moral transgression falls within its realm. This case is a prime example of that principle.”).
263. O’Hagan, 92 F.3d at 628. (“O’Hagan was disbarred in Minnesota, and served a 30-month sentence after being convicted in Minnesota state court for invading clients’ trust funds.”).
VI. CONCLUSION

One does not have to agree with the Supreme Court’s holding to respect what the Court has accomplished with its opinion in United States v. O’Hagan. The Court clarified a confusing line of Supreme Court cases and gave a full explanation of the Eighth Circuit’s mis-steps in interpreting the Supreme Court’s holdings. The Court also gave valuable insight into the weight of policy considerations when interpreting section 10(b). However, only time will tell whether the Court’s opinion in fact settled a complicated issue, or simply created more confusion regarding the application of the misappropriation theory to factual scenarios different from the one in O’Hagan.

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