

10-1-1998

A Redundancy of Remedies: Insider Trading and *United States v. O'Hagan*, a Comparison of Sections 10(b) and 14(e) of the Securities Exchange Act of 1934 under the Misappropriation Theory

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COMMENTS

A Redundancy of Remedies: Insider Trading and *United States v. O'Hagan*, a Comparison of Sections 10(b) and 14(e) of the Securities Exchange Act of 1934 under the Misappropriation Theory

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I. INTRODUCTION

A. *Rise in Governmental Interest to Cure Abuses in the Securities Industry*

Since the Great Depression of 1929, the Federal Government has shown a stark retreat from a laissez-faire philosophy in which it left regulation of the stock markets substantially up to market forces. Congress believed that the Great Depression was a direct result of irresponsible behavior of the stock exchanges and, accordingly, has taken a much more active role in the regulation of the markets.¹ Although

1. Congress' belief that much more aggressive regulation was needed is most apparent in the following remarks by Senator King which prefaced the extensive debates that accompanied the Securities Exchange Act of 1934:

securities regulation has been prevalent throughout the majority of this century, the prosecution of insider trading² has been a recent phenomenon finding its roots in caselaw dating only three decades old.³ Although young, this doctrine has blossomed into one of the most significant areas of securities regulation.⁴

The rising interest in insider trading in the 1990s is not at all surprising when one considers the fact that the late 90s have seen a boom in the Mergers and Acquisitions ("M&A") field. The year of 1997 saw a proliferation of M&A activity that spanned all industries.⁵ Whatever effect this phenomenon has on the health of national and international economies, one effect is certain—the rise in M&A activity is a very

Mr. President, several years ago, and upon one or two occasions since, I introduced measures, which were referred to the Committee on Banking and Currency, and which, in my opinion, if they had been enacted into law, would have prevented the debacle of 1929 so far as the stock exchange, stock sales, and so forth, are concerned. Unfortunately, no action was taken with respect to those measures. I am now introducing a bill to establish a Federal stock exchange and securities commission, to regulate transactions in securities on the various stock exchanges, and for other purposes.

78 CONG. REC. 1991 (1934) (remarks by Senator King upon introduction of S. 2642), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 634 (1983).

2. Insider trading is most commonly found to be a violation of §10(b) of the Securities Exchange Act of 1934 ("§10(b)"), 15 U.S.C. § 78j(b) (1988), and SEC Rule 10b-5 ("Rule 10b-5"), 17 C.F.R. § 240.10b-5 (1997), promulgated thereunder by the Securities and Exchange Commission. Section 10(b) states, in pertinent 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. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Similarly, Rule 10b-5 states, in pertinent part:

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

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

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3. *See* Cady, Roberts & Co., Exchange Act Release No. 6668, 40 S.E.C. 907 (November 8, 1961).

4. The burgeoning of liability premised upon § 10(b) has been metaphorically described as "a judicial oak which has grown from little more than a legislative acorn." *United States v. O'Hagan*, 92 F.3d 612, 622 (8th Cir. 1996).

5. One theory for the increase in M&A activity is that firms are acquiring other firms in order to acquire a talented labor force during a booming economy that has resulted in a scarcity of talented labor due to high employment rates. *See* Bernard Wysocki Jr., *Many Mergers Driven By Search For Fresh Talent*, CHI. TRIB., Dec. 28, 1997, at 67C.

tempting enticement to insiders who may attempt to use nonpublic information regarding a planned tender offer by purchasing stock or options in a target firm and then cashing in to reap substantial profits.⁶

B. *Misappropriation vs. Classical Theory*

The Supreme Court decided *United States v. O'Hagan*⁷ in the middle of 1997 during a maelstrom of ideologies concerning insider trading. These doctrinal differences still exist today and are housed in two schools of thought: the "classical theory" of insider trading and the "misappropriation theory" of insider trading. Under the "classical theory:"

§10(b) and Rule 10b-5 are violated when a corporate insider trades in the securities of his corporation on the basis of material, nonpublic information. Trading on such information qualifies as a "deceptive device" under §10(b) . . . because "a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation." [This] relationship . . . "gives rise to a duty to disclose [or to abstain from trading] because of the necessity of preventing a corporate insider from . . . tak[ing] unfair advantage of . . . uninformed . . . stockholders."⁸

The "misappropriation theory," on the other hand,

[H]olds that a person commits fraud "in connection with" a securities transaction, and thereby violates §10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information. Under this theory, 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. In lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information.⁹

Thus, the classical theory emphasizes the relationship between the parties to the transaction, whereas the misappropriation theory emphasizes the relationship between the trader and the source of the information. At the time *O'Hagan* was under consideration, the misappropriation theory

6. When a tender offer is announced, usually the price of the target company rises and the price of the offeror falls or remains the same. See *SEC v. Maio*, 51 F.3d 623, 628 n.3 (7th Cir. 1995).

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

8. *Id.* at 2207 (citations omitted).

9. *Id.* (citations omitted).

had been officially endorsed by the United States Court of Appeals for the Second¹⁰, Seventh¹¹, and Ninth¹² Circuits and had been rejected by the Fourth¹³ and Eighth Circuits¹⁴.

C. *Background of United States v. O'Hagan*

James Herman O'Hagan ("O'Hagan") was a partner in the law firm of Dorsey and Whitney in Minneapolis.¹⁵ Grand Metropolitan PLC ("Grand Met") retained the firm to represent Grand Met regarding a potential tender offer¹⁶ for the stock of Pillsbury Company ("Pillsbury").¹⁷ The firms underwent measures to protect the confidentiality of these plans.¹⁸ O'Hagan did not perform any work associated with the tender offer; however, he acquired confidential information about the deal through deceptions of a fellow partner at Dorsey and Whitney who was working on the deal.¹⁹ During Dorsey and Whitney's representation of Grand Met, O'Hagan purchased a substantial amount of call options²⁰ as well as shares of common stock in Pillsbury.²¹ When Grand Met announced its tender offer, the price of Pillsbury stock nearly doubled and O'Hagan reaped profits totaling more than \$4.3 million.²²

A subsequent Securities and Exchange Commission ("SEC") investigation led to a 57-count indictment that alleged that O'Hagan defrauded his law firm and its client, Grand Met, by using material, non-public information regarding Grand Met's planned tender offer for his own trading purposes.²³ Among the 57 counts listed in the indictment were 17 counts of securities fraud, in violation of §10(b) and SEC Rule

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

11. See *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991).

12. See *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

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

14. See *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996).

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

16. A tender offer is an attempt by a bidder to acquire control of a public company (the "target") through the acquisition of some or all of the target's outstanding shares through a bid made directly to the target's shareholders who will "tender" their shares in return for cash at a price which is above the current market price. See Samuel C. Thompson, Jr., *BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS* 13 (1977).

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

18. See *id.*

19. See Petitioner's Brief 1997 WL 86306 at *4, *United States v. O'Hagan*, 117 S. Ct. 2199 (1997) (No. 96-842).

20. A call option gives the holder the right to purchase a specified number of shares of stock by a certain date at a specific price. If the shares are not purchased by that date, the option expires and along with it the right to purchase the specified number of shares. See *O'Hagan*, 92 F.3d at 614 n.1.

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

22. See *id.*

23. See *id.*

10b-5, as well as §14(e) of the Securities Exchange Act of 1934 and SEC Rule 14e-3(a),²⁴ promulgated thereunder.²⁵ A jury convicted O'Hagan on all counts, and he was sentenced to a 41-month term of imprisonment.²⁶

On appeal, the Court of Appeals for the Eighth Circuit reversed all of O'Hagan's convictions.²⁷ The Eighth Circuit rejected the validity of the misappropriation theory²⁸ (which was used to prosecute O'Hagan who did not have a fiduciary duty with the seller of the securities, i.e. Pillsbury's stockholders, but did have a fiduciary duty with the source of the confidential information, Dorsey and Whitney and Grand Met, Dorsey and Whitney's client).²⁹ The Eighth Circuit premised its rejection of the misappropriation theory on the grounds that it failed to take into account two elements necessary to maintain a prosecution under §10(b):

24. As will be elaborated upon in this paper, prosecutions under §14(e) of the Securities Exchange Act of 1934 ("§14e"), 15 U.S.C. § 78n(e) (1988), frequently accompany §10(b) violations. Section 14(e) proscribes fraudulent trading in connection with a tender offer. Specifically, §14(e) states:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The [Securities and Exchange] Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

The SEC invoked Congress' grant of rulemaking authority and promulgated Rule 14e-3(a), 17 C.F.R. § 240.14e-3(a) (1998) which states, in pertinent part:

If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the [Securities Exchange Act of 1934] for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know is nonpublic and which he knows or has reason to know has been acquired directly or indirectly from:

- (1) The offering person,
- (2) The issuer of the securities sought or to be sought by such tender offer, or
- (3) Any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or to dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

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

26. See *id.*

27. See *id.* at 2206.

28. See *id.*

29. See *id.* at 2208 n.5 and n.6.

1) a misrepresentation or nondisclosure which is 2) in connection with the purchase or sale of any security.³⁰ Furthermore, the Eighth Circuit reversed the counts based on Rule 14e-3(a) under the belief that the SEC had exceeded its rule-making authority in promulgating Rule 14e-3(a).³¹ The Supreme Court reversed the Eighth Circuit on both of these holdings.³²

D. *Outline of Comment*

This comment will analyze, in three parts, the evolution of insider trading jurisprudence and the investor protections and remedies that have resulted from this jurisprudence. Part II of the comment will outline the judicial interpretations of § 10(b) and culminate in an analysis of the Court's opinion in *O'Hagan*. Part III will trace the legislative history of §10(b) and §14(e) with a particular focus on the structural framework and the underlying purposes upon which the two provisions were enacted (something courts have been hesitant to do). Finally, Part IV will attempt to form a synthesis of Parts II and III and analyze whether the Supreme Court's articulation of insider trading jurisprudence in *O'Hagan* provides adequate protection for investors or whether it provides redundant remedies. Ultimately, this paper will conclude that, assuming *O'Hagan* is correct in its holding that the SEC did not exceed its rulemaking authority in promulgating Rule 14e-3(a), the misappropriation theory is merely a redundancy that can be ignored since misappropriation cases may come under the authority of §14(e) or possibly under a tipper/tippee analysis of the classical theory. This conclusion is due to the fact that the misappropriation theory is largely a response to the unique problems encountered while prosecuting insider trading cases in the M&A context.

30. See *United States v. O'Hagan*, 92 F.3d 612, 618 (The court stated, "[w]e reject the misappropriation theory, in part, because it permits the imposition of §10(b) liability based upon the mere breach of fiduciary duty without a particularized showing of misrepresentation or nondisclosure . . . We need not tarry long on this point, however, because . . . [the theory] 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").

31. Prosecutions under § 10(b), whether under the classical or misappropriation theory, require the existence of some fiduciary relationship. The Eighth Circuit held that since Rule 14e-3(a) did not require this fiduciary element and, in fact, provided its own definition of fraud, the SEC exceeded its rulemaking authority in §14(e). See *id.* at 624.

32. See *O'Hagan*, 117 S. Ct. at 2206.

II. JUDICIAL INTERPRETATION OF INSIDER TRADING JURISPRUDENCE

A. §16(b)

Interestingly enough, §16(b)³³, as opposed to §10(b), was the first piece of legislation courts invoked to prosecute those engaged in insider trading.³⁴ In fact, §16(b) is the only provision in the entire Securities Exchange Act of 1934 which explicitly states that its purpose is to address insider trading concerns. The provision explicitly states that:

For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized . . . within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer.³⁵

Thus, §16(b) provided a somewhat strong but short term incentive for insiders not to abuse their fiduciary status for profit by allowing a disgorgement of any profits they may obtain through the activity (albeit only if the transactions took place within a six-month time frame).

In *Adler v. Klawans*,³⁶ the Second Circuit gave not only an interpretation of §16(b) but also an enlightening look at the overall structure of the securities laws as they applied to insider trading. The issue in *Adler* was whether a director had to relinquish profits made on sales of a corporation's stock that were sold while he was holding his office but purchased before he took the office. In holding that the profits were covered under §16(b), the court made the following statements about insider trading:

The undoubted congressional intent in the enactment of §16(b) was to discourage what was reasonably thought to be a widespread abuse of a fiduciary relationship—specifically to discourage if not prevent three classes of persons from making private and gainful use of information acquired by them by virtue of their official relationship to a corporation. The objective was not to punish but to deter the persons in these three categories—directors, officers, 10% beneficial owners—from making improper use of information gained in a representative capacity. The practices could not be prevented *in toto* but Congress sought to take the profit out of what it considered improper conduct.³⁷

Thus, the Second Circuit in *Adler* believed that Congress had provided a

33. 15 U.S.C. § 78p(b) (1988).

34. See *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959).

35. 15 U.S.C. § 78p(b) (1988).

36. *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959).

37. *Id.* at 844.

relatively weak remedy for insider trading. Furthermore, the court stated that:

Large areas of 'insider' conduct were consciously left untouched by Congress for reasons dictated by practicalities rather than ethics or pure logic. A line had to be drawn somewhere by the lawmakers, as they must do in the laws of marriage, divorce, legitimacy, real estate, wills and a host of other subjects governed by statute.³⁸

One can see that the Second Circuit believed insider trading to be only lightly touched by the securities laws. It is ironic that this same Circuit would eventually become the most zealous advocate for an expansionary reading of §10(b).

B. *Cady, Roberts & Co.'s Introduction of §10(b) as a Remedy
Against Insider Trading*

Section 16(b) proved too light a remedy to combat the evils of insider trading, and the SEC responded to the need for a more powerful remedy in the administrative case of *Cady, Roberts & Co.*³⁹ In this case, the SEC, for the first time, articulated §10(b) and Rule 10b-5's interpretation as a prohibition against insider trading. The SEC had to determine the duties of a broker after receiving non-public information about a company's dividend action from a director who was employed by the same brokerage firm.⁴⁰ Chairman Cary determined that the broker (whose actions were considered those of the firm) had to disclose material facts which were known to him by virtue of his position but which were not known to persons with whom he dealt.⁴¹ Chairman Cary went further to state that if disclosure prior to effecting a purchase or sale would be improper or unrealistic under the circumstances, then the alternative is to forgo the transaction.⁴² From this, we get the often-cited, *Cady, Roberts* "disclose or abstain" rule.

In ruling as it did, the Commission rejected *Adler's* narrow interpretation of the Exchange Act stating, "[t]hese anti-fraud provisions are not intended as a specification of particular acts or practices which constitute fraud, but rather are designed to encompass the infinite variety of devices by which undue advantage may be taken of investors and others."⁴³ Upon a cursory analysis, it would appear that the SEC endorsed the misappropriation theory even in the early days of insider

38. *Id.* at 845.

39. *Cady, Roberts & Co.*, Exchange Act Release No. 6668, 40 S.E.C. 907 (November 8, 1961).

40. *See id.* at 907.

41. *See id.* at 912.

42. *See id.* at 911.

43. *Id.*

trading enforcement.⁴⁴ However, this analysis fails given Chairman Cary's statements in *Cady, Roberts* that, "our task . . . is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited."⁴⁵ Thus, the Commission seemed to be content at this point to enforce only the classical theory.

In *SEC v. Capital Gains Research Bureau, Inc.*,⁴⁶ the Supreme Court stated that its interpretation of the securities laws led it to believe that the provisions should be read "flexibly to effectuate [their] remedial purpose[s]" and not "technically and restrictively."⁴⁷ The Court here dealt with provisions of the Investment Advisers Act of 1940;⁴⁸ however, it was explicit that it's theory applied to all of the securities laws.

The Second Circuit adopted the Supreme Court's more expansive view of insider trading liability in *Shapiro v. Merrill Lynch*⁴⁹ by recognizing that tippees (recipients of confidential, non-public information) are just as liable as the insider for insider trading.⁵⁰ However, in discussing the liability of these tippees, the court stated that "the essential purpose of Rule 10b-5 is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders."⁵¹ Thus, the Second Circuit appears to have been thinking expansively with regards to only the classical theory.

C. Restrictions on the Scope of Rule 10b-5

The Supreme Court seemed intent on expanding the reach of §10(b) as an antifraud provision as evidenced in *Capital Gains*; however, the Court also restricted §10(b)'s reach in *Blue Chip Stamps v. Manor Drug Stores*⁵² and *Santa Fe Industries, Inc. v. Green*.⁵³ In *Blue Chip Stamps*, the Court examined the "in connection with the purchase or sale" requirement and concluded that in a private damage action under §10(b) and Rule 10b-5, the plaintiff class was limited to the actual purchasers and sellers of securities.⁵⁴ Thus, the Court made official note of the "in

44. Of course, this would not be an unexpected event, as one would be surprised to see an administrative agency give a restrictive reading to the statutes upon which it bases its authority.

45. *Cady, Roberts & Co.*, 40 S.E.C. at 912.

46. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

47. *See id.* at 195.

48. *See* 15 U.S.C. § 80b-1 et seq.

49. *Shapiro v. Merrill Lynch*, 495 F.2d 228 (2d Cir. 1974).

50. *See id.* at 236.

51. *Id.* at 235.

52. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

53. *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

54. *See Blue Chip Stamps*, 421 U.S. at 731-32.

connection with" element and recognized a needed relationship between the actual purchasers and sellers of the securities in question and the insider trader. This would appear to strengthen the case for the classical theory.

Similarly, the Court in *Sante Fe Industries, Inc.* emphasized that Rule 10b-5 could not exceed its authority as derived from §10(b). In *Sante Fe*, the Court refused to find a §10(b) violation where minority shareholders claimed that a corporation's parent company was not valuing their stock appropriately when exercising its right under a Delaware "short-form merger" statute to merge with its subsidiary so long as the corporation bought back the minority shareholders' shares.⁵⁵ The Court recognized that §10(b) required some form of deception which was not apparent and stated that a mere breach of fiduciary duty without any deception, misrepresentation, or nondisclosure, did not violate §10(b).⁵⁶ Of particular interest to the Court was the existence of other avenues to gain relief such as through the Delaware Courts of Chancery.⁵⁷ The Court articulated its point stating that the "fundamental purpose of the Act [is] implementing a philosophy of full disclosure; once full and fair disclosure has occurred, the fairness of the terms of the transactions is at most a tangential concern of the statute."⁵⁸ Thus, the Court reaffirmed the doctrine that §10(b) was not intended to remedy all breaches of conduct and had to be confined to the subset of breaches for which it was intended.

D. *The Tender Offer Cases and the Introduction of the Misappropriation Theory*

Santa Fe Industries foreshadowed the litigation of the next two decades that led up to *O'Hagan*—a frenzy of cases set in the M&A context. As stated earlier, M&A deals can offer large temptations to an insider due to the effect the deals have on the stock price of the target firm. The inherent difficulty in prosecuting M&A insider trading cases, however, stems from the structure of the particular deal. Since there are at least two participating firms, the potential for "insiders" can come from two sources, either the target firm or the acquiring firm. Therefore, there will be a good chance that an individual who wishes to capitalize off of inside information does not have a fiduciary relationship with the firm whose stock he/she is trading (almost always the target firm).

55. See *Santa Fe Industries, Inc.*, 430 U.S. at 466.

56. See *id.* at 475-76.

57. See *id.* at 467.

58. *Id.* at 478.

Because classical insider trading doctrine could not apply to these scenarios, the courts (and Congress) responded to this dilemma.

The Supreme Court initially addressed this concern in *Chiarella v. United States*.⁵⁹ Chiarella was a financial printer whose employer had been engaged by certain corporations to print corporate takeover bids.⁶⁰ In accordance with the large degree of secrecy and confidentiality required in performing these deals, the corporations made it a practice not to include the identities of the acquiring or target firms.⁶¹ These areas were replaced by blank spaces or false names, and the true names were sent to the printer on the night of the final printing.⁶² Chiarella, however, was able to deduce the identities of the parties and, accordingly, made trades on the stocks of the target firms and reaped substantial profits.⁶³ The Supreme Court reversed Chiarella's conviction on the grounds that Chiarella had no duty to disclose his trades since he did not have a fiduciary relationship with the shareholders of the target firm for which he traded.⁶⁴ The Court repeated its sentiments from *Santa Fe Industries, Inc.* stating that "not every instance of financial unfairness constitutes fraudulent activity under §10(b)."⁶⁵ The Court further stated that "neither the Congress nor the Commission ever adopted a parity-of-information rule."⁶⁶ Thus, the Court in *Chiarella* maintained the position of earlier cases that §10(b) was not meant to function as a cure-all for all financial woes and that other remedies, if available, should be sought.⁶⁷

In spite of the Supreme Court's reluctance to rule on the validity of the misappropriation theory in *Chiarella*, the Second Circuit quickly endorsed it in *United States v. Newman*.⁶⁸ Newman was a securities trader who received misappropriated confidential information from investment bankers who had been entrusted with the information by corporate clients concerning proposed mergers and acquisitions.⁶⁹ The

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

60. *See id.* at 224.

61. *See id.*

62. *See id.*

63. *See id.*

64. *See id.* at 231. Of course, the Supreme Court's holding in *O'Hagan* changes the doctrine in that now a fiduciary relationship with the source will maintain a prosecution under §10(b) as well. Query: Would this change the holding in *Chiarella* given that there was not a relationship of confidence and trust considering the fact that the firms hid the identities of the participating firms until the time of final printing?

65. *Id.* at 232.

66. *Id.* at 233.

67. The Court actually did consider the misappropriation theory but failed to rule on its validity as it had not been presented to the jury at the trial level. *See id.* at 236.

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

69. *See id.* at 15.

court reasoned that a deception had occurred in that the trading sullied the reputations of the investment banks as safe repositories of client confidences.⁷⁰ Furthermore, the court explicitly noted that the misappropriation theory was being offered by the government "to remedy the deficiency [found] in *Chiarella*."⁷¹ Thus, the Second Circuit recognized the inherent difficulty of prosecuting insider trading in the M&A perspective using the classical theory and instead applied the misappropriation theory as an avenue around the dilemma.⁷²

The Supreme Court placed an obstacle to the rising acceptance of the misappropriation theory in *Dirks v. SEC*.⁷³ The Court stated, "[W]e reaffirm today that a duty to disclose arises from the relationship between parties and not merely from one's ability to acquire information because of his position in the market."⁷⁴ The Court expressed concern that imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider (as *Dirks* had done) and trades on it could have an inhibiting influence on the role of market analysis.⁷⁵ Furthermore, although *Dirks* was not a misappropriation case but a case involving the tipper/tippee doctrine of the classical theory, the Court seemed to respond to the concerns of the circuits that believed that the misappropriation theory was the only viable avenue to remedy M&A insider trading cases. Specifically, the Court stated:

We do not suggest that knowingly trading on inside information is ever "socially desirable or even that it is devoid of moral considerations" . . . Nor do we imply an absence of responsibility to disclose promptly indications of illegal actions by a corporation to the proper authorities in cases involving securities But in a statutory area of the law such as securities regulation, where legal principles of general application must be applied, there may be "significant distinctions between actual legal obligations and ethical ideas."⁷⁶

Therefore, according to the *Dirks* Court, the possible reprehensible nature of the insider trading does not give a court carte blanche authority to read a statute in whatever manner will most conveniently ensure a conviction.

70. *See id.* at 17.

71. *See id.* at 15.

72. For other cases in which courts have turned to the misappropriation theory as an avenue for dealing with the unique situations that arise in the M&A context, see, e.g., *SEC v. Maio*, 51 F.3d 623 (7th Cir. 1995); *SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990).

73. *Dirks v. SEC*, 463 U.S. 646 (1983).

74. *Id.* at 657-58.

75. *See id.* at 658.

76. *Id.* at 661 n.21 (citations omitted).

E. *Subsequent Expansions of the Misappropriation Theory*

Despite the Supreme Court's statements in *Dirks*, courts continued to pursue the misappropriation doctrine as a means to prosecute insider trading; in fact, new and more novel uses of the misappropriation theory evolved. In *United States v. Reed*⁷⁷, the Southern District of New York refused to dismiss an indictment of a trader who traded shares of stock of a corporation based upon non-public confidential information about an upcoming merger the company was engaged in.⁷⁸ The interesting aspect of this case was that the trader acquired the information through conversations with his father, a member of the board of directors of the firm with whose stock the trader dealt.⁷⁹ Since the indictment did not allege that the father provided the information for the improper purpose of exploiting the information for personal gain, the classical theory would not have provided a basis for liability.⁸⁰ Instead, the United States Attorney proceeded on a misappropriation theory, arguing that the son had a fiduciary relationship with his father which he breached by using the information conveyed to him without disclosing the trading activities to his father.⁸¹ The court engaged in an exhaustive analysis of what constitutes a fiduciary relationship and, ultimately, left it to the trier of fact to determine.⁸² *Reed* is an excellent example of the slippery slope that courts have gone down in attempting to use the misappropriation theory to prevent the doctrinal holes that M&A deals afford to insiders.

A more expansive interpretation of the misappropriation theory can be found in *United States v. Carpenter*.⁸³ In *Carpenter*, a reporter/writer for the Wall Street Journal used and passed on to his co-conspirators non-public information, which he obtained in his professional capacity, to speculate in the stock market.⁸⁴ Notwithstanding these unique facts, the Second Circuit held that a violation of §10(b) had occurred.⁸⁵ The court reasoned that the reporter had breached the fiduciary duty that he held with the Wall Street Journal.⁸⁶ Furthermore, the court held that the "in connection with" requirement was satisfied by the writer's use of the misappropriated information for his financial benefit which caused a

77. *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985).

78. *See id.* at 737.

79. *See id.* at 690.

80. *See id.* at 693-94 n.15.

81. *See id.* at 695.

82. *See id.* at 712-17.

83. *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986).

84. *See id.* at 1026.

85. *See id.* at 1036.

86. *See id.* at 1032.

financial detriment to those investors with whom he traded.⁸⁷ The court concluded its analysis with a policy statement, namely that “[to] hold otherwise would undermine Congress’ ideal in 1934 of an open and honest market in which superior knowledge in the securities markets would be achieved honestly, fairly, and without resort to pernicious conduct.”⁸⁸

Carpenter is probably the farthest reaching of the misappropriation cases. Unlike the previous cases, it does not take place in the M&A context. Even more startling, however, is the fact that it assigns liability to a trader for conduct which would not violate §10(b) had it been done by the trader’s employer. The Wall Street Journal could have traded based on the information it had gathered, and it would not have been liable for insider trading since it did not have a fiduciary duty to the firms it reported on.⁸⁹ Yet, the reporter was liable for the conduct solely due to his status as a fiduciary of the newspaper. Such inequitable application of the law does not occur in the M&A context.

This principle can be illustrated using the facts of *O’Hagan*. James O’Hagan was found liable for insider trading due to his status as a fiduciary with Dorsey and Whitney (the source of his information).⁹⁰ Furthermore, had Dorsey and Whitney committed the same acts as O’Hagan, it also would have been liable due to its status as a fiduciary of Grand Met via the attorney-client relationship. To take the analysis one step further, if management or members of the board of Grand Met had decided to trade based on the information, they too would have been liable since they had a fiduciary duty to Grand Met (or, more accurately, to the shareholders of Grand Met), the source of their information. Thus, liability is distributed regardless of the status of the parties.⁹¹ It is for this reason that if the misappropriation theory is to be used at all, it should be confined to the M&A context.

F. *Misappropriation Theory Dissenters*

Despite the Second Circuit’s vigorous attempts to promote the misappropriation theory, some circuits dissented, particularly the Fourth and

87. *See id.*

88. *Id.* at 1036.

89. Of course, practically speaking the *Wall Street Journal* would probably not engage in this behavior since to do so would alert the business community; and the *Journal* would, more than likely, quickly find information gathering to be a difficult endeavor. This does not change the legal implications of the inequitable application of the law to the parties.

90. *See United States v. O’Hagan*, 117 S. Ct. 2199, 2220 (1977).

91. *See Carpenter*, 794 F.2d at 1033. This anomaly was pointed out to the court. Apparently the court believed that the business practicalities of running a major newspaper (i.e. protection of reputation, etc.) was sufficient to outweigh the concern. This concern for business practicalities does not, however, give a justification for the inequitable application of the law.

Eighth Circuits in *United States v. Bryan*⁹² and *United States v. O'Hagan*⁹³ respectively. Both circuits believed that the courts that recognized the misappropriation theory validated the theory on the basis of the assumed unfairness of allowing an individual to trade securities on the basis of information that is not available to other traders.⁹⁴ The circuits could not allow this policy reason to overrule what was, in their opinion, the correct interpretation of the law. In fact, the Eighth Circuit, in *O'Hagan*, expressed its concern as to how the Second Circuit decided *Newman* without quoting or discussing the language of §10(b), without citing to *Santa Fe* with its language regarding not unduly expanding the securities laws, and without significantly analyzing *Chiarella*.⁹⁵ Specifically, the Fourth and Eighth Circuits rejected the misappropriation theory because it permitted the imposition of §10(b) liability without a showing of misrepresentation or nondisclosure, only the misappropriation of information.⁹⁶ Furthermore, these circuits appeared particularly disturbed by the belief that the misappropriation theory did not call for the violation to be "in connection with the purchase or sale of a security," since it merely called for the breach of a duty owed to individuals who "are unconnected to and perhaps uninterested in a securities transaction."⁹⁷

G. *O'Hagan's Attempts at Resolution*

The Supreme Court finally resolves the conflict among the circuits in *United States v. O'Hagan*.⁹⁸ The Court follows the example set by the Second Circuit and, in upholding the validity of the misappropriation theory, largely uses a pragmatic rationale stressing the importance of eliminating insider trading due to the unfair advantages it affords privileged parties.⁹⁹

With regards to the question of whether the misappropriation theory included the requisite deception element, the Court concludes that this element is included due to the fact that "misappropriators . . . deal in

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

93. *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996).

94. *See id.* at 621.

95. *See id.*

96. *See id.* at 618.

97. *See id.*

98. *O'Hagan*, 117 S. Ct. at 2199.

99. *Id.* at 2207-08. ("The misappropriation theory is . . . designed to protect the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders").

deception.”¹⁰⁰ To illustrate this principle, the Court draws an analogy between the fraudulent misappropriation of information and embezzlement, the fraudulent misappropriation of money; it concludes that both involve deception.¹⁰¹

Furthermore, the Court states that the “in connection with” requirement of §10(b) is satisfied “because the fiduciary’s fraud is consummated not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities.”¹⁰² The Court, thus, engages in a hindsight analysis by imputing knowledge that the misappropriated information will be used in connection with the purchase or sale of securities to the time when the information is misappropriated. The Court supports its theory by engaging in several assumptions about events that could surround the misappropriator’s actions.¹⁰³ For example, when confronted with the prospect that O’Hagan could have profited from the information by selling the information to Pillsbury or using it to entice Pillsbury to use him for legal work, the Court discounts the idea stating that a firm would have large doubts about engaging a lawyer who readily betrayed a client’s confidence.¹⁰⁴ Also, when the Court is confronted with the notion that a misappropriator may disclose his trades to his source of information and may then escape §10(b) liability while continuing to trade and harm investors, the Court suggests that the source may seek appropriate equitable relief under state law.¹⁰⁵

The Court handles the insider trading precedent in various ways. First, it distinguishes *Santa Fe* by confining it to its facts and pointing out that all the pertinent facts in that case were disclosed by the person charged with violating §10(b) and, therefore, there was no deception.¹⁰⁶ It then reduces the precedential value of *Chiarella* by pointing out that the case left open the question of the validity of the misappropriation theory since that theory had not been presented to the jury and was, thus, not analyzed.¹⁰⁷ Finally, the Court discounts *Dirks* by explaining that *Dirks* was not found liable because the insiders in that case had acted not for personal profit, but to expose a massive fraud within the corporation.¹⁰⁸

100. *Id.* at 2208. (“[the misappropriator] pretends loyalty to the principal while secretly converting the principal’s information for personal gain”).

101. *See id.* at 2209.

102. *Id.*

103. *Id.*

104. *See id.* at 2210 n.8.

105. *See id.* at 2209.

106. *See id.*

107. *See id.* at 2212.

108. *See id.* at 2213.

The Court then addresses the issue of whether Rule 14e-3(a) represented action on the part of the SEC which exceeded its rulemaking authority. The Court concludes that it did not need to resolve whether the SEC's authority under §14(e) to define such acts and practices as fraudulent is broader than its fraud-defining authority under §10(b). It reasons that Rule 14e-3(a) as it applied to cases similar to *O'Hagan* qualified "under §14(e) as a 'means reasonably designed to prevent' fraudulent trading on material, nonpublic information in the tender offer context."¹⁰⁹ The Court, thus, holds that under §14(e), the SEC could prohibit acts, not themselves fraudulent under the common law or §10(b) if the prohibition is reasonably designed to prevent acts and practices that are fraudulent.¹¹⁰ This holding means that prosecutions under §14(e) do not require the existence of a fiduciary duty as required in §10(b) prosecutions. Thus, there is a less rigorous requirement, assuming the insider's transactions are being conducted within a tender offer context.

III. LEGISLATIVE HISTORY OF INSIDER TRADING

In their attempts to use the legislative history to discern an understanding of §10(b), courts have been frustrated with the fact that there is a scarce amount of information regarding the provision.¹¹¹ What many of these courts fail to do, however, is to look at the general scope of the entire Securities Exchange Act of 1934 and how the various provisions work together. By engaging in this form of analysis, one sees a clearer picture of what Congress intended pertaining to insider trading.

A. *Ultimate Goals of Securities Exchange Act of 1934*

The ultimate goals of the Securities Exchange Act of 1934 are readily apparent when one looks at the Senate and House Reports, as well as communications from President Franklin D. Roosevelt, regarding the bill. In the President's opinion, the legislation was intended to accomplish two goals, one substantive and one procedural.¹¹² The substantive

109. *See id.* at 2217. There is a strong argument, therefore, that the question of whether the SEC exceeded its rulemaking authority in promulgating Rule 14e-3(a) is still an open one to be resolved at a later date. For purposes of analyzing 14e-3(a) as it relates to 10b-5, however, it is assumed that the SEC did not exceed its rulemaking abilities.

110. *See id.*

111. *See United States v. Carpenter*, 796 F.2d 1024, 1030 (2d Cir. 1986) (noting paucity of legislative history on §10(b)).

112. The letter reads, in pertinent part:

The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted "boom" which had so much to do with the terrible conditions of the years following 1929 . . . The two

goal was to halt excessive margin transactions¹¹³ that the President believed was a major cause of the economic disaster of the Great Depression.¹¹⁴ The procedural goal was to grant authority to the federal government to oversee the stock exchanges so that it could ensure another economic crash did not occur.¹¹⁵ It follows that President Roosevelt's primary focus was on restricting the use of margin accounts in the stock market.

Congress agreed with the President in the halting of excessive margin transactions but expanded upon the goals of the Exchange Act. In Congress' view, the Act had three objectives: 1) preventing the excessive use of credit for speculation (this is the corollary to President Roosevelt's margin transactions), 2) ending the unfair practices employed in speculation, and 3) minimizing the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities.¹¹⁶ Congress' concerns are addressed primarily in

principal objectives [of the legislation] are, as I see it—First, the requirement of what is known as "margins" so high that speculation even as it exists today, will of necessity be dramatically curtailed; and Second, that the Government be given such definite powers of supervision over exchanges that the government itself will be able to correct abuses which may arise in the future. We must, of course, prevent insofar as possible manipulation of prices to the detriment of actual investors, but at the same time we must eliminate unnecessary, unwise, and destructive speculation.

S. Rep. No. 73-792, at 2 (1934) (accompanying S. 3420), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 709 (1983).

113. Margin transactions involve speculation in securities with borrowed money. *See id.* at 6.

114. *See id.*

115. *See id.*

116. *See id.* at 5. The House of Representatives expressed similar objectives. *See* H.R. Rep. No. 73-1383, at 5 (1934) (accompanying H.R. 9323), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 794 (1983). Congress, in fact, explicitly codified its objectives in §2 of the Securities Exchange Act, 15 U.S.C. § 78b. §2 provides:

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto. . .

(1) Such transactions. . . involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce and affect the national credit. . .

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the

§ 7¹¹⁷ (Margin Requirements), § 9¹¹⁸ (Prohibition Against Manipulation of Security Prices), § 12 and § 13¹¹⁹ (Registration Requirements for Securities and Periodical and Other Reports) of the Exchange Act. Understanding these objectives is crucial for an understanding of § 10(b) because all other provisions of the Exchange Act revolve around them.

B. *Insider Trading Provisions*

Interestingly enough, members of Congress did have insider trading in their minds when they drafted the Exchange Act; however, the legislative history indicates that Congress meant to remedy it through the use of § 16¹²⁰ which contains provisions requiring the reporting of any change in the holdings of directors, officers, and principal shareholders of a corporation.¹²¹ The Senate Report also makes mention of § 16(b) which, as discussed above, allows a corporation to recover any profits made from the selling of stock by an insider within a six month period.¹²² Specifically, the Senate Report states:

The bill further aims to protect the interests of the public by preventing directors, officers, and principal stockholders of a corporation, the stock of which is traded in on (sic) exchanges, from speculating in the stock on the basis of information not available to others. Any change in the holdings of such insiders must be reported to the Commission, and profits realized from the purchase and sale, or the sale and purchase of an equity security within a period of less than 6 months are recoverable by the corporation. Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information regarding an increase or resumption of dividends in some cases, and the passing of dividends in others.¹²³

In fact, the most glaring proof of Congress' intention to use § 16(b) as the primary means for preventing insider trading is in a section of the House Report entitled "Control of Unfair Practices by Corporate Insiders" which states, in pertinent part:

Because it is difficult to draw a clear line as a matter of law between

fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

117. 15 U.S.C. § 78(g) (1988).

118. 15 U.S.C. § 78(i) (1988).

119. 15 U.S.C. § 78(l)-(m) (1988).

120. 15 U.S.C. § 78(p) (1988).

121. *See* S. Rep. No. 73-792 at 9 (1934).

122. *See id.*

123. *Id.*

truly inside information and information generally known by the better-informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity. For that reason, this bill requires the disclosure of the corporate holdings of officers and directors and stockholders owning more than 5 percent of any class of stock, and prompt disclosure of any changes that occur in their corporate holdings.¹²⁴

Thus, Congress appears to have intended §16 to regulate the problem of insider trading.

This does not mean, however, that Congress did not envision a role for § 10 in the scheme of insider trading. In fact, § 10 plays a very important role in Congress' plan to attack insider trading, but this role is in the form of §10(a)'s restrictions of short sales¹²⁵ and not necessarily §10(b)'s catch-all provision. The House Report makes mention of §10(a)'s restrictions against short selling as a preventive measure to stop insider trading.¹²⁶ Furthermore, some of the most heated debates on the floor of Congress concerned certain members' perceptions of short selling as a speculative evil that helped to bring about the Great Depression.¹²⁷ Thus, one of the central goals of the Securities Exchange Act of 1934, elimination of excess speculation, is seen to be a part of § 10.

Finally, another indication of Congress' intent to use other provisions to enforce insider trading is the fact that in the House version of the bill, § 10 contained no subsection (b).¹²⁸ Subsection (b) was not added in until the House and Senate met in joint conference and the

124. H.R. Rep. No. 73-1383 at 13 (1934).

125. A "short sale" "is a contract for sale of shares [of stock] which the seller does not own or certificates for which are not within his control so as to be available for delivery at the time when, under rules of the exchange, delivery must be made." *Provost v. U.S.*, 269 U.S. 443, 450-51 (1926).

126. See H.R. Rep. No. 73-1383 at 13 (1934).

127. Congressman Sabath expressed the Congress' concern with short sales on the House floor with a recitation of facts about the Stock Exchange including the fact that, "[n]ot one fourth of the transactions on the exchange are sales where the seller actually parts with the security, and is paid for it by the purchaser." 78 Cong. Rec. 7689 (1934) (remarks by Mr. Sabath regarding H.R. 9323), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 823 (1983).

128. The original House version of the provision read as follows:

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, to effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, 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.

H.R. 9323, 73d Cong., 2d Sess. (1934), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 755 (1983).

House agreed to add the provision.¹²⁹

C. *Growth of §14*

Section 10 has not been amended since its original enactment with the rest of the Securities Exchange Act. In contrast, §14 has undergone two amendments that pertain to §14(e). The original version of §14 did not possess a subsection (e). It merely regulated the use of proxies and mandated that users of proxies had to obey rules promulgated by the SEC.¹³⁰ Subsection (e) was added as a result of the Williams Act.¹³¹ Congress believed that by adding an antifraud provision in the form of subsection (e), it was affirming the fact that persons engaged in making or opposing tender offers (or otherwise seeking to influence the decision of investors or the outcome of the tender offer) are under an obligation to make full disclosure of material information to those with whom they deal.¹³² Lastly, subsection (e), itself, was amended in 1970 to add a provision which authorizes the SEC to define and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.¹³³

IV. SYNTHESIS

Ultimately, after observing the doctrinal evolution in the judicial interpretation of insider trading jurisprudence coupled with the legislative history behind §10 and §14, one must conclude that 1) the misappropriation theory applies optimally to cases that come to courts from the M&A context, and 2) §14(e) is more applicable to resolve M&A cases than §10(b) is. These two observations lead us to the conclusion that the misappropriation theory is not needed in lieu of §14(e).

Regarding the misappropriation theory's optimal use in the M&A context, as explained above, courts gave birth to the theory due to the unique problems encountered in this arena. Whereas under the classical theory, exploiters of inside information would escape judicial scrutiny as a result of the absence of a fiduciary relationship between the trader and

129. See H.R. Rep. No. 73-1838, at 23 (1934) (Conference Report), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 1179 (1983).

130. See § 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a) (1988).

131. 82 Stat. 454, Pub. Law 90-439 and 84 Stat. 1497, Pub. Law 91-567. The Williams Act was enacted because Congress perceived special disclosure and protection problems which consumers faced in a tender offer context. See S. Rep. No. 90-550, at 1 (1967), *reprinted in* 1 FEDERAL BAR ASSOCIATION SECURITIES LAW COMMITTEE, FEDERAL SECURITIES LAWS LEGISLATIVE HISTORY 1933-1982, at 2107 (1983).

132. See S. Rep. No. 90-550, at 1 (1967).

133. See 84 Stat. 1497, Pub. Law 91-567.

the shareholders of the company upon which he is trading, the exploiter is liable under the misappropriation theory since he has committed a deception against the source of the nonpublic information. Courts may, therefore, be correct in applying the misappropriation theory to M&A cases.

They are not correct, however, in applying the same analysis to cases which do not occur within the M&A paradigm. Proof of this theory is evident by looking at the inequitable treatment that the law affords in a *Carpenter v. United States* scenario. The SEC's zeal for preventing insider trading should not be so rampant as to allow for a situation where two parties will be afforded completely different treatment due solely to their status in a transaction.¹³⁴ This is particularly true in a criminal context where courts allot severe sanctions for violations of the law. Thus, the misappropriation theory, if it is accepted at all (given the substantial amount of precedent mandating that § 10(b) not be unduly expanded), must be applied solely to cases occurring within the M&A paradigm.

However, if the above proposition is accepted, there exists a redundancy of remedies in the law. Section 14(e), as stated above, provides a far broader net of protection than § 10(b) which is restricted to cases involving a fiduciary duty (whether it be to shareholders or the source of information). Thus, when a case arises in the M&A context, § 14(e) will be available to address the concern making the need for § 10(b) a nullity.

This theory is further bolstered by Congress' actions concerning § 10(b) and § 14(e). If § 10(b) was intended to address cases of this nature, why did Congress feel it necessary to enact § 14(e) thirty three years later? Congress' refusal to amend § 10(b) and its choice to make subsequent amendments to § 14 provide evidence of its intent to ultimately use § 14(e) as the sole remedy for the illegal use of confidential information in the M&A context.¹³⁵

It must be noted, however, that there may be a policy argument to the effect that the misappropriation theory is necessary in M&A deals that do not utilize a tender offer and, therefore, do not fall within the purview of § 14(e)¹³⁶ and would only be addressed by § 10(b). This

134. The typical argument is, of course, why should an individual such as Carpenter escape liability even though he has committed acts of fraud? The counter to this argument, however, is that the individual does not escape as he is still subject to certain State law remedies for breaches of duty as well as to non-legal sanctions such as having his employment terminated.

135. The Court in *O'Hagan* recognized this in oral argument asking Counsel for the Government whether 14(e) provided them with an easier argument for liability than 10(b). See generally United States Supreme Court Transcript 1997 WL 182584, *United States v. O'Hagan*, No. 96-842 (April 16, 1997).

136. Section 14(e) and all rules promulgated thereunder only apply to transactions involving tender offers. See 15 U.S.C. § 78n(e) (1988).

argument fails though when one realizes that in the cases where this analysis is required, lawsuits can be filed under a separate legal theory or brought against other parties. A review of two cases, *United States v. Reed*¹³⁷ and *United States v. Chestman*¹³⁸, will be illustrative.

As stated above, in *Reed*, a young man traded in the securities of a firm for which his father served as director.¹³⁹ The son traded based upon material, nonpublic information that the father provided to the son regarding the merger of the firm with another company.¹⁴⁰ The government indicted the son based upon the misappropriation theory by reasoning that the son breached a fiduciary duty with his father via their family relationship.¹⁴¹

Although the government was very creative, it did not need to go through the trouble of crafting such an elaborate argument to prosecute the son. It could have merely proceeded to prosecute the son under the classical theory of insider trading as the son was a "tippee" who assumed a fiduciary duty to the shareholders of the corporation not to trade on material, nonpublic information which he obtained improperly from an insider.¹⁴² The father's breach of duty to the shareholders paved the way for a tipper/tippee analysis. The case is distinguishable from that in *Dirks* in that the conveyance of information was not intended to benefit the company. Furthermore, recourse could have been sought against the father in that he breached his duty of care as a director of the corporation by carelessly sharing confidential information with his son. Accordingly, the father was subject to shareholder derivative suits. Again, a misappropriation analysis showed itself to be an unnecessary redundancy.

Chestman further refutes arguments which favor the misappropriation theory. In *Chestman*, an officer and shareholder of a potential target corporation in a tender offer shared information about the offer with his sister, who was also a shareholder in the firm.¹⁴³ The sister, in turn, shared the information with her husband; he shared the information with his stockbroker, Robert Chestman, who traded based upon it.¹⁴⁴ Ironically, §14(e) applied because a tender offer was used. However, had the transaction occurred in the context of a negotiated merger, no relief

137. *United States v. Reed*, 601 F. Supp. 685 (S.D.N.Y. 1985).

138. *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

139. *See Reed*, 601 F. Supp. at 689.

140. *See id.*

141. *See id.*

142. *See Dirks v. SEC*, 463 U.S. 646, 660 (1982).

143. *See Chestman*, 947 F.2d at 555.

144. *See id.*

would have been available under § 14(e) or under the classical theory since the officer had not improperly disclosed the information.

It is even more ironic that in a case where the misappropriation theory would have been truly useful, it failed. The Second Circuit held the theory inapplicable as it reasoned that a sufficient fiduciary relationship did not exist between the husband and his family.¹⁴⁵ Here, the stockbroker would have escaped liability had it not been for the protections afforded by § 14(e).

However, even had the misappropriation theory applied in *Chestman*, the case is illustrative of why the theory is not an effective substitute. In many cases, the target firm will probably have enough outside stockholders that any interested bidder would find a tender offer to be the most useful tool to acquire a sizable amount of the target's outstanding shares of stock. In a firm that has a lesser number of shareholders or that possesses a capitalization structure in which the bulk of the outstanding shares are owned by insiders, a negotiated merger may be the preferred acquisition tool in order to acquire additional representations and warranties. However, in the negotiated merger situation there is a greater chance that the source of the inside information will be an officer or director of the company (as in *Reed*) since a rise in stock price may be anticipated for both parties and not solely for one (the target). If this is the case and the director leaks the information *improperly*,¹⁴⁶ then liability may arise under the classical theory under a tipper/tippee analysis and traditional corporate remedies (suits against directors for breach of duty of care and loyalty, etc.) are available. True, traditional corporate remedies may lack a criminal sanction; however, as stated earlier in this comment, criminality is too harsh a sanction to impose based upon a theory as unclear as the misappropriation theory.

Of course, one could conceive of a *Chestman*-like scenario in which none of the alternative remedies would be available. For example, using the facts of *O'Hagan*, had Grand Met only entered into a negotiated merger with Pillsbury and O'Hagan acquired information regarding this merger from an insider in a way that was not improper, then O'Hagan would not be liable under any basis other than the misappropriation theory. However, given the underlying purpose and spirit of the William's Act that was designed to address just such dilemmas (although only explicitly in the context of a tender offer), it seems more appropriate that Congress should simply amend §14 to include this ana-

145. See *id.* at 570.

146. Given the high degree of secrecy surrounding transactions of this sort leaks may more often than not qualify as having been done improperly.

lytical gap rather than allow an entire new body of jurisprudence to address it.

V. CONCLUSION

The SEC's Division of Enforcement must always remain vigilant against forces that would seek to exploit secret information at the expense of shareholders. However, this vigilance does not have to come in the form of the misappropriation theory. There is a strong argument that the misappropriation theory fails to address the vast array of precedent that warned against unduly expanding the scope of §10(b) liability. Furthermore, the misappropriation theory fails to take into account the "in connection with the purchase or sale of any security" requirement. The United States Supreme Court's only attempt to reconcile its adoption of the theory with this requirement is to engage in a hindsight analysis and create a presumption that all misappropriations will result in the trading of securities.¹⁴⁷ Such presumptions are quite dangerous, particularly in a criminal context. The SEC is not rendered helpless by a declaration of the misappropriation theory as void given the breadth and power of §14(e) which was specifically tailored for these types of transactions as well as the applicability of the tipper/tippee analysis of the classical theory. The SEC should rely solely on the classical theory of insider trading when prosecuting most insider trading cases and use §14(e) for those cases which involve the unique set of facts particular to those arising in the tender offer context.

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147. Post-O'Hagan courts have been more reluctant to stretch insider trading jurisprudence. See *SEC v. Adler*, 137 F.3d 1325, 1337 (11th Cir. 1998) (holding that proof that an insider traded while in possession of material nonpublic information is not a per se violation). Query: Why should courts be more at ease in assuming that the misappropriation of information will lead to trading than they are to assume that an insider used material nonpublic information to conduct his or her trades?

* I dedicate this Comment to my parents, Nathaniel and Andrea Davis, as well as to my sister, Kimberly Davis, who provided the support necessary for me to grow and thrive in both my educational and professional career. I also dedicate this Comment to Samuel C. Thompson, Jr., Dean of the University of Miami School of Law, who provided guidance to me as I wrote this comment and as I mapped out my career in the area of Corporate and Securities Law.